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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

BOWATER INCORPORATED AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, in determining the source of a multinational taxpayer's income under Treasury Regulation § 1.861-8(e), the interest expense to be allocated and apportioned is net interest expense, that is, gross interest expense minus offsetting interest income.

PARTIES TO THE PROCEEDINGS

Bowater Incorporated has no parent companies. It has two non-wholly-owned subsidiaries: Calhoun Newsprint Company (whose remaining shares are owned by Herald Company, Inc., a non-public company); and Bowater Mersey Paper Company, Ltd. (whose remaining shares are owned by The Washington Post Company, a publicly-traded company).

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PETITION FOR A WRIT OF CERTIORARI

Bowater Incorporated respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-12a) is reported at 108 F.3d 12. The opinion of the Tax Court (App. 17a-28a) is reported at 101 T.C. 207.

JURISDICTION

The judgment of the court of appeals (App. 13a-14a) was entered on March 3, 1997. The taxpayer's petition for rehearing with suggestion for rehearing en banc was denied on June 9, 1997 (App. 15a-16a). On August 26, 1997, Justice Ginsburg extended the time within which to petition for a writ of certiorari to and including October 7, 1997 (App. 40a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of §§ 861(b) and 994(a) of the Internal Revenue Code, 26 U.S.C. ("the Code" or "IRC"), and of §§ 1.-861-8 and 1.994-1 of the Treasury Regulations on Income Tax, 26 C.F.R. (1978) ("Treas. Reg."), as in effect during the tax years in issue, are reprinted in App. 32a-39a.

STATEMENT

1. Section 861(b) of the Code and its accompanying regulations govern the allocation and apportionment of expenses, including interest expense, in computing a taxpayer's domestic-source and foreign-source income. This allocation affects numerous determinations under the Code, most notably the calculation of a taxpayer's foreign tax credit. Here, it arises in determining the taxable income of a domestic international sales corporation ("DISC"). Congress enacted the DISC provisions in 1971 to stimulate exports from the United States by allowing DISCs to defer tax on part of their export income.

Bowater is the parent of a multinational corporate group that produces paper, wood pulp and related forest products. It is the largest producer of newsprint in the United States. During the tax years in issue, Bowater had two subsidiaries, Carolina and Southern, that in turn owned DISCs. The DISCs served as commission agents for those two companies' export sales. Carolina and Southern are referred to as the DISCs' "related suppliers." App. 4a, 19a.

To compute the DISCs' income, Bowater elected the "50/50 combined taxable income" method set forth in § 994(a)(2) of the Code. This method allows a DISC to earn income equal to 50% of the combined taxable income that the DISC and its related supplier derive from export sales. App. 4a, 20a-21a. The regulation defines "combined taxable income" as the DISC's gross receipts from export sales, minus all costs

"definitely related" to export sales and "a ratable part of any other expenses, losses and deductions." Treas. Reg. § 1.994-1(c)(6)(iii). The regulation requires that the allocation between export and other income of these latter expenses, including interest expense, shall be "determined in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8."

The allocation of interest expense is governed by Treas. Reg. § 1.861-8(e)(2). It adopts "the approach that money is fungible and that interest expense is attributable to all activities and property" of the taxpayer. "This approach recognizes that all activities and property require funds," that "management has a great deal of discretion as to the source and use of funds," and that money borrowed for any particular purpose "will generally free other funds for other purposes." Treas. Reg. § 1.861-8(e)(2)(i). The regulation accordingly provides that interest expense, described as "the cost of borrowing," is "allocable to all the gross income which the income-producing activities and property of the taxpayer generate." *Id.* § 1.861-8(e)(2)(i) & (ii). This regulatory scheme will be referred to hereafter as "the fungibility principle."

Carolina, Southern and their DISCs incurred gross interest expense during 1979 and 1980 of $1.4 million and $1.9 million, respectively, on general corporate indebtedness. App. 19a. Carolina and Southern also earned substantial interest income on inter-company loans of surplus cash to their parent. App. 19a-20a.[1] Applying the fungibility principle contained in the governing regulation, Bowater netted the gross interest income of Carolina and Southern against the gross interest expense of

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[1] Under IRC § 482, loans between related taxpayers must bear interest at an arm's-length rate. *See* Treas. Reg. § 1.482-2(a). There is no dispute that the subsidiaries' loans to their parent comported with arm's-length norms. App. 20a n.1.

Carolina, Southern, and their DISCs in order to determine the actual cost of those companies' borrowing. Bowater then allocated the resulting net interest expense — approximately $250,000 in 1979 and $140,000 in 1980 — between export and other income in computing the taxable income of the DISCs.

On audit of Bowater's tax returns, the Commissioner determined that the regulations require allocation of gross, rather than net, interest expense. By increasing the interest expense charged against export receipts, the Commissioner substantially reduced Bowater's tax-deferred DISC income, generating tax deficiencies of $320,400 in 1979 and $686,700 in 1980 attributable to this issue. App. 5a.

2. Bowater sought redetermination of the deficiencies in the Tax Court, which ruled for the taxpayer. Following the Fifth Circuit's decision in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), the Tax Court held that the amount of interest expense to be allocated under Treas. Reg. § 1.861-8(e)(2) is net interest expense.

In the Tax Court, "both parties recognize[d] that this regulation does not expressly state whether or not netting of interest is allowed." App. 23a. The Court noted, however, that the regulation requires allocation among the taxpayer's various activities of "the cost of borrowing." *Id.*, quoting Treas. Reg. § 1.861-8(e)(2)(i). According to the Tax Court, "[n]et interest expense is the actual cost of borrowing," namely, "interest expense on the debt incurred, reduced by the interest earned on the investment of any temporary cash surplus." App. 26a-27a.

In holding that net interest expense is "the total cost of borrowing" (App. 26a), the Tax Court adopted the reasoning of the Fifth Circuit in *Dresser*. As the Fifth Circuit explained, businesses (other than banks) typically borrow money not to earn interest income, but rather to finance their operations. "To

reduce the cost of holding [borrowed] funds until they are actually needed," a corporation will typically invest in short-term, interest-bearing instruments. And because it may be impractical to retire long-term obligations prior to maturity, a business "will typically invest any cash surplus to offset the cost of carrying its long-term debt." *Dresser*, 911 F.2d at 1135, quoted in App. 25a. "In either case," the Fifth Circuit held, "the total *cost of the borrowing* is the interest expense on the debt incurred, reduced by the interest earned on the investment of any temporary cash surplus." 911 F.2d at 1135 (emphasis original), quoted in App. 25a.

The Tax Court concluded that netting interest income against interest expense faithfully implements the fungibility principle of Treas. Reg. § 1.861-8(e)(2) "because both focus on the underlying economic realities." According to the Tax Court, "[n]etting of interest avoids unequal treatment of taxpayers with the same amount of actual interest cost, just as the fungibility of interest concept avoids unequal treatment of taxpayers whose indebtedness is structured differently." App. 24a. The Tax Court found that the Commissioner's contrary position not only ignores the realities of corporate borrowing, but illogically "assumes its own conclusion: that interest income should be considered separately, and not netted with interest expense." App. 25a. Because "net interest is the actual cost of borrowing," the Tax Court held that the Commissioner's proposed gross-interest allocation would improperly "burden a DISC with a disproportionate share of the actual borrowing costs of all operations." App. 26a.

3. The court of appeals reversed (App. 3a). It declined to follow the Fifth Circuit's decision in *Dresser*, adopting instead the Commissioner's position that Treas. Reg. § 1.861-8(e)(2) requires allocation of gross, rather than net, interest expense.

According to the court of appeals, the Fifth Circuit in *Dresser* "relie[d] on its own judicial version of 'economic reality' to justify allocation of interest expense to interest income before any remaining interest expense is allocated to other income producing activities." App. 7a-8a. "Whatever might be said about *Dresser's* theory of the 'true cost of borrowing,'" the court of appeals concluded that the Fifth Circuit's theory "does not comport with the Regulation's concept that money is fungible." App. 8a. The Second Circuit emphasized the regulation's requirement that the cost of borrowing be allocated to "all income producing activities" of the taxpayer, which it interpreted to include the activity of producing interest income. App. 5a. It accordingly held that "Taxpayer's — and *Dresser*'s — version of the 'true cost of borrowing' has no basis in the Regulation." App. 9a. "In any event," the Second Circuit stated that "the plain language of the Regulation does not give us the latitude to interpret it based on impressions of how businesses 'typically' conduct their affairs, or on economic theories of what constitutes 'the true cost of borrowing.'" *Ibid.*

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals creates a direct conflict among the circuits on an issue of substantial importance in international taxation. The proper method for apportioning interest expense is not limited to computation of DISC income; to the contrary, it arises in a large number of distinct tax settings, all of great significance to multinational taxpayers. The question presented is now pending in numerous IRS audits involving very substantial tax liabilities, and decision of this issue will ultimately affect the tax liabilities of virtually all U.S.-based multinational corporations. Resolution of this important, recurring question is needed to avoid continuing

uncertainty, to prevent repetitive and wasteful litigation, and to ensure even-handed application of the tax laws.

1. The decision of the Second Circuit in this case directly conflicts with the decision of the Fifth Circuit in *Dresser*, 911 F.2d 1128. The Fifth Circuit in *Dresser* squarely held that net interest expense represents the actual cost of borrowing; it accordingly interpreted Treas. Reg. § 1.861-8 to require that net interest is the amount of interest to be allocated to various categories of income. By contrast, the Second Circuit in this case dismissed "*Dresser*'s theory of 'the true cost of borrowing'" and held that the regulation requires allocation of gross interest expense unreduced by interest income. App. 8a.

The two decisions conflict, not only in their holdings, but also in their underlying rationales. Whereas the Second Circuit believed that "[t]he plain language of Treasury Regulation § 1.861-8(e)(2) controls the outcome" (App. 5a), the Fifth Circuit in *Dresser* found the regulation to be inexplicit or ambiguous. While agreeing that the regulation, given a literal reading, does not expressly require netting, the Fifth Circuit observed that "the same literal reading does not preclude such an approach" either. *Dresser*, 911 F.2d at 1134-1135. The Fifth Circuit accordingly considered Congressional purpose, legislative history, and the economic realities of corporate borrowing in deciding that "the cost of borrowing," as that term is used in the regulation, should be interpreted to mean *net* rather than *gross* interest expense.

This conflict among the circuits is no less direct because the two courts of appeals considered different versions of the regulation. The tax years at issue in *Dresser* were 1976-1977, and that case was accordingly controlled by Treas. Reg.

§ 1.861-8(a), originally promulgated in 1957.[2] However, there is no meaningful difference between the two versions of the regulation in terms of the question presented here. Both versions require the apportionment of interest expense to all categories of gross income. And neither version of the regulation specifies whether the "interest expense" to be apportioned is *net* or *gross* interest expense.

The strength of this conflict is underscored by the fact that the Fifth Circuit in *Dresser* specifically relied upon Treas. Reg. § 1.861-8(e)(2) — the version of the regulation at issue here — to support its conclusion that netting of interest is required. The Fifth Circuit had previously decided a case involving the allocation of interest expense to "gross income from mining" for purposes of computing a taxpayer's depletion allowance under IRC § 613. *See General Portland Cement Co. v. United States*, 628 F.2d 321 (5th Cir. 1980), *cert. denied*, 450 U.S. 983 (1981). In *General Portland*, the court reasoned that the amount of interest to be apportioned is the taxpayer's "actual cost for interest on borrowed funds," and it held that a "[t]axpayer's actual cost for interest is its 'net' interest expense." 628 F.2d at 344. In deciding that the same analysis

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[2] The version of the regulation considered by the Fifth Circuit in *Dresser* provided as follows:

> From the items of gross income specified in §§ 1.861-2 to 1.861-7, inclusive, as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income.

Treas. Reg. § 1.861-8(a) (as amended in 1975). Section 1.861-8(e) of the regulations, which governs the instant case, was promulgated in 1977, applicable to tax years beginning after December 31, 1976. *See* Treas. Reg. § 1.861-8(a)(5)(ii).

should apply in *Dresser*, the Fifth Circuit specifically relied on the subsequent version of the regulation that is involved here (911 F.2d at 1135):

> In providing for the allocation and apportionment of interest under code section 861, the current Treasury Regulations take the approach that money is fungible. *See* Treas. Reg. § 1.861-8(e)(2)(i) (as amended in 1988). According to the regulations, "[t]his approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds." * * * Although the current Treasury Regulations are not controlling in the case at bar, this particular passage does illustrate the fundamental principle we expounded in *General Portland.*

On the Fifth Circuit's view, Treas. Reg. § 1.861-8(e)(2) simply made explicit the fungibility principle inherent in the earlier version of the regulation, and the court held that this fungibility principle dictates that net interest is the amount of interest to be allocated under § 861.

Thus, the Fifth Circuit in *Dresser* expressly considered the version of the regulation involved in the instant case and concluded that this version is consistent with — indeed, supports — its conclusion that netting of interest is required under the § 861 regulations. In so doing, the Fifth Circuit made clear that it would interpret both versions of the regulation in the same way. There can accordingly be no doubt that the Fifth Circuit would decide the instant case in a manner opposite to that in which the Second Circuit decided it, and hence that the two decisions are in direct conflict.

2. In refusing to follow *Dresser*, the Second Circuit has injected confusion into a body of tax law that had been well-settled until now. The question whether interest expense

should be allocated to classes of income on a gross or a net basis first arose in the depletion context. *See General Portland Cement Co. v. United States*, 628 F.2d 321 (5th Cir. 1980), *cert. denied*, 450 U.S. 983 (1981). As noted earlier, the Fifth Circuit there held that netting is required because the "[t]axpayer's actual cost for interest is its 'net' interest expense." 628 F.2d at 344. The Tax Court reached the same conclusion in a subsequent depletion case. *See Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. 352, 402 (1984). The Commissioner explicitly acquiesced in both of those decisions. *See* IRS Actions on Decision 1986-022 & 1986-023 (Feb. 26, 1986), *reprinted in* 1986 IRS Positions Rptr. (CCH) ¶¶ 44,022 & 44,023.

The Fifth Circuit in *Dresser* subsequently ruled that net interest is likewise the amount of interest required to be allocated under the § 861 regulations. And *Dresser* has been followed by the Tax Court, not only in the instant case, but in two other opinions authored by different judges. *See The Coca-Cola Company & Subsidiaries v. Commissioner*, 106 T.C. 1, 4, 31 (1996); and *Computervision Int'l Corp. v. Commissioner*, 71 T.C.M. (CCH) 2451, 2465 (1996). On each occasion, the Tax Court has held that the fungibility principle enunciated in *Dresser* and expressly set forth in the regulation involved here dictates that net interest is the amount of interest to be allocated under § 861.

In holding that the regulation "is clear on its face" and that "*Dresser*'s * * * version of the 'true cost of borrowing' has no basis in the Regulation" (App. 5a, 9a), the Second Circuit has departed from this well-established body of law. It has thus reached a result at odds, not only with the Fifth Circuit and the fungibility principle, but also with business realities and common sense. As the Fifth Circuit explained in *Dresser*, businesses other than financial institutions do not borrow

money to generate interest income, but rather to finance their operations. 911 F.2d at 1135. If a business has a temporary cash surplus, it may use this cash to retire debt; but that course of action may be undesirable for any number of reasons, including the high transaction costs incident to retiring long-term obligations. Instead of retiring debt, the taxpayer may opt to reduce its overall cost of borrowing by placing surplus funds in temporary interest-bearing instruments. The Fifth Circuit correctly concluded that the tax consequences should not depend on which course of action a corporation chooses.

Section 1.861-8(e)(2) of the Treasury Regulations recognizes that a company's management has great flexibility in the timing and total amount of borrowing and in deciding the potential uses for borrowed funds. The Fifth Circuit properly interprets this fungibility principle in a way that achieves equality between similarly-situated taxpayers. A taxpayer that chooses to retain larger amounts of debt, yet reduce the cost of that borrowing by earning interest on temporary cash investments, should receive the same results under Treas. Reg. § 1.861-8(e) as the taxpayer that uses cash to retire debt. In either case, the taxpayer's actual cost of borrowing is its net interest expense.

The economic logic of the Fifth Circuit's approach is vividly illustrated by the facts of the instant case. The interest income earned by Bowater's two subsidiaries derived principally from short-term inter-company loans to their parent corporation. *See* App. 19a-20a. Instead of loaning the cash to their parent, the subsidiaries could have used the money to pay off third-party debt, particularly short-term lines of credit used for operating capital. In that event, they would have had virtually no interest income, and their "gross" and "net" interest expense would have been substantially identical.

As *Dresser* and its progeny properly hold, the fungibility principle contained in Treas. Reg. § 1.861-8(e)(2) dictates that the tax consequences should not differ depending on the vagaries of taxpayers' debt structures and cash-management practices. Bowater here borrowed short-term funds from its subsidiaries, resulting in a smaller amount of debt being carried by them and a larger amount of debt being carried by it. If indebtedness is treated as fungible in making interest allocations — as the governing regulation requires — the export income earned by the subsidiaries and their DISCs should not fluctuate depending on the particular application of funds that prudent cash management dictates. The netting of interest income against interest expense eliminates this fluctuation and thus achieves the uniform outcomes contemplated by the fungibility principle of Treas. Reg. § 1.861-8(e)(2).

3. The question presented is very important, in a highly practical sense, to orderly administration of the tax laws. The allocation of interest expense to domestic-source and foreign-source income under § 861 affects a multiplicity of computations under the Internal Revenue Code. The proper allocation procedure is crucial, for example, in computing the foreign tax credit, which has a major effect on the tax liability of all U.S. companies with significant overseas operations. In 1994, U.S. taxpayers claimed foreign tax credits aggregating in excess of $25 billion. *See* Internal Revenue Service, 16 Statistics of Income Bulletin 204, Table 13 (Spring 1997).

The amount of a company's creditable foreign taxes is affected by its foreign-source income, and foreign-source income in turn is determined by the amount of interest and other expenses charged against such income. The proper allocation of interest expense thus affects computation of the "overall limitation" on the foreign tax credit (Treas. Reg. § 1.-904-1(b)(1)), the "separate limitations" on the credit (Treas.

Reg. § 1.904-4(c)(2)), the "look-through rules" applicable to transactions with related parties (Treas. Reg. § 1.904-5(c)(2)(ii)), and the determination of "overall foreign losses" (Treas. Reg. § 1.904(f)-1(c)(3)). Companies that conduct oil and gas operations abroad must apply Treas. Reg. § 1.861-8(e) to compute taxable income or loss from various categories of foreign income, which critically affects the magnitude of their foreign tax credit. *See* Treas. Reg. § 1.907-1(f)(2) & 2(d)(2). In 1992, taxpayers engaged in oil and gas extraction claimed foreign tax credits in excess of $450 million. Internal Revenue Service, 15 Statistics of Income Bulletin 117, Table 1 (Winter 1995-1996).

Resolution of the question presented is also of critical importance to a variety of entities that have been created with great frequency in recent years to take advantage of legislative tax incentives. The methodology for apportioning interest expense under § 861 affects multiple computations that must be made by "foreign sales corporations" ("FSCs"). *See* Treas. Reg. § 1.921-3T(b) (determination of foreign trade income); *id.* § 1.921-3T(d)(3)(ii) (determination of separate foreign tax credit limitation); *id.* § 1.925(a)-1T(c)(6)(iii)(D) (determination of total costs related to FSC gross receipts). The question presented affects "possessions corporations" established in Puerto Rico and other U.S. possessions in much the same manner as it affects the DISCs involved here. *See* Treas. Reg. § 1.936-6(b)(1)(Q&A1); *The Coca-Cola Company & Subsidiaries v. Commissioner*, 106 T.C. 1, 4, 31 (1996) (following *Bowater* and holding that net interest expense is the amount of interest to be allocated in determining income of § 936 affiliate). In 1994, U.S. taxpayers claimed possessions tax credits aggregating in excess of $3.7 billion. Internal Revenue Service, 16 Statistics of Income Bulletin 204, Table 13 (Spring 1997). Finally, the § 861 apportionment methodology affects computation of the interest income included in the

earnings of a "passive foreign investment company," to list just one more example. *See* Proposed Treas. Reg. § 1.163(j)-4(d)-(2)(ii).

The question presented is thus important to virtually all U.S.-based multinational corporations in a variety of different ways. Unless the existing circuit conflict is resolved, litigation in all these areas may be expected to increase dramatically as taxpayers outside the Second Circuit rely on *Dresser* and a consistent line of Tax Court decisions as "substantial authority" for computing their tax liabilities on a net-interest basis.[3] Meanwhile, taxpayers in the Second Circuit will be required to use a gross-interest allocation by virtue of the panel's decision in this case.

The question presented not only affects a large number of taxpayers in a great variety of ways; it also involves very significant amounts of revenue. In a limited survey of approximately 100 companies conducted by a leading trade association, more than half the respondents indicated that the interest-allocation issue is currently being raised on audits of their tax returns, with this issue involving aggregate tax liabilities in the range of $65 million. These controversies span years from 1979 to the present and thus concern the proper allocation of interest expense under three distinct versions of the governing regulation.

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[3] If a taxpayer has "substantial authority" for its treatment of an item on its tax return, it has a complete defense to the § 6662 "accuracy-related penalty" with respect to that item, even if the taxpayer does not disclose the relevant facts on the return. *Compare* IRC § 6662(d)(2)(B)(i) *with* IRC § 6662(d)(2)(B)(ii)(I). This means that taxpayers may in effect "play the audit lottery" by claiming net-interest treatment on their returns, without fear of penalties if their position is detected and challenged by IRS on audit.

In 1988, the Treasury Department again amended § 1.861-8 of the regulations, effective for tax years beginning after December 31, 1986. These new temporary regulations continue the fungibility principle, using language identical to that used by the regulation involved here. However, the amended regulation includes an additional sentence stating: "The term interest refers to the gross amount of the interest expense incurred by a taxpayer in a given year." Temp. Treas. Reg. § 1.861-9T(a). The Justice Department in this case informed the court of appeals that the new temporary regulation "simply serves to clarify the Commissioner's position" and that "the concept of fungibility did not change from one iteration of this regulation to another." Brief for the United States at 11, *Bowater, Inc. v. Commissioner*, 108 F.2d 12 (2d Cir. 1997). The Second Circuit agreed that "the temporary regulation merely reiterates, or clarifies, the Regulation at issue here" and found no evidence that it "substantially changed the rules for the apportionment of interest expense." App. 12a.

For all these reasons, the new temporary regulation has little impact on the legal analysis involved in deciding the question presented here. By the same token, this Court's decision of the instant case would provide crucial guidance for courts called upon to interpret the temporary regulation in the future. Ultimately, the courts will have to decide the proper interpretation of the regulations. Unless this Court resolves the existing circuit conflict, there will be many years of wasteful litigation and increasing inequities among taxpayers depending on their circuit of residence.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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Appendix

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT.

No. 335, Docket 96-4039.

BOWATER, INC. AND SUBSIDIARIES,
formerly known as Bowater Holdings, Inc.,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Argued Sept. 30, 1996.

Decided March 3, 1997.

Commissioner of Internal Revenue appealed decision of the Tax Court, John O. Colvin, J., allowing corporate taxpayer to net interest income against interest expense before allocating interest expense to combined taxable income of taxpayer and its wholly owned domestic international sales corporations (DISC). The Court of Appeals, William A. Norris, Circuit Judge, sitting by designation, held that taxpayer was required by regulation to allocate interest expense ratably to all income producing activities to calculate combined taxable income of taxpayer and DISC.

Reversed.

Robert T. Carney, Washington, DC (Fulbright & Jaworski, Washington, DC, on the brief), for Petitioner-Appellee.

David E. Carmack, Attorney, Tax Division, Department of Justice, Washington, DC (Loretta C. Argrett, Assistant Attorney General, Gary R. Allen, Pamela C. Berry, Attorneys, Tax Division, Department of Justice, Washington, DC, on the brief), for Respondent-Appellant.

Before: KEARSE, NORRIS [1], and LEVAL, Circuit Judges.

WILLIAM A. NORRIS, Circuit Judge:

This appeal requires us to interpret a Treasury regulation that was in effect during the tax years 1979 and 1980. The Regulation provides in part: "[T]he aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate." 26 C.F.R. § 1.861-8(e)(2)(ii) (1978).[2] In *Dresser Ind., Inc. v. Commissioner,* 92 T.C. 1276, 1286, 1989 WL 64601 (1989), the Tax Court interpreted the Regulation in favor of the Commissioner, reasoning that the Regulation spoke of

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[1] Honorable William A. Norris, of the United States Court of Appeals for the Ninth Circuit, sitting by designation.

[2] We refer to § 1.861-8(e)(2) of the 1978 Treasury regulations as "the Regulation." The relevant portion of the Regulation provides in full:

> § 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities. . . .
>
> (e) Allocation and apportionment of certain deductions
>
> (1) In general. Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense. . . .
>
> (2) Interest
>
> (i) In general. The method of allocation and apportionment for interest set forth in this paragraph (e)(2) is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purposes for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Normally, creditors of a

allocating interest expense among all income producing activities, including activities that produce interest income, and did not provide "for the netting of interest income and expense before allocation and apportionment." *Id.* at 1285-86. The Tax Court's decision in *Dresser* was reversed by the Fifth Circuit. *Dresser Ind., Inc. v. Commissioner,* 911 F.2d 1128 (5th Cir. 1990). In this case, the Tax Court followed *Dresser* without question. We think the Tax Court had it right the first time, and we reverse its decision for the taxpayer.

I

Bowater, Inc. (Taxpayer) is a domestic corporation that produces wood pulp and other related products for sale to customers. During 1979 and 1980, Taxpayer wholly owned Bowater Southern Paper Corporation and Bowater Carolina Corporation. Southern Paper and Carolina Paper, in turn, wholly owned other corporations that qualified as domestic international sales corporations (DISCs) under § 992(a)[3] of

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> taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.
>
> (ii) Allocation of interest. Except as provided in subdivisions (iii) and (iv) of this subparagraph [Note: These exceptions are not applicable here.], the aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate.

26 C.F.R. § 1.861-8(e)(2)(i) & (ii) (1978).

[3] All statute references are to the Internal Revenue Code of 1954 in effect during the tax years in issue.

the Internal Revenue Code.[4] During the relevant tax years, income from export sales that qualified as DISC income received highly preferential tax treatment in that DISC income escaped corporate tax and was taxed solely to its shareholders, with a portion of that tax deferred. *See* 26 U.S.C. §§ 991, 995(b), (c).

To compute the amount of its DISCs' income, Taxpayer used the "50/50 combined taxable income" method set forth in § 994(a)(2). This method limits a DISC's taxable income to 50% of the "combined taxable income" (CTI) of the DISC and its related supplier attributable to export sales. The regulations pertaining to § 994(a)(2) provide that the expenses to be deducted from gross receipts in calculating CTI shall be determined in a manner consistent with § 1.861-8 of the regulations. 26 C.F.R. § 1.994-1. Accordingly, as the parties agree, we must interpret § 1.861-8 to decide this case.

In 1979 and 1980, Taxpayer filed consolidated federal income tax returns with its DISCs and their related suppliers. In the returns, Taxpayer computed the CTIs of its DISCs and their related suppliers by first allocating interest expense to interest income before allocating a portion of the remaining interest expense to income generated by the sales of export property through the DISCs. The effect of computing the CTIs in this manner was to reduce the portion of Taxpayer's taxable income that was not related to DISC export sales, thereby increasing the portion of Taxpayer's taxable income that was attributable to DISC export sales, which in turn increased the portion of taxable income subject to the highly preferential tax treatment afforded to DISC income. The Commissioner claims that in shifting interest

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[4] The names of the DISCs are Southern Export Corporation and Carolina Export Company. For convenience, we refer to them as "DISCs," and to Southern Paper and Carolina Paper as their "related suppliers."

expense away from DISC income in order to maximize DISC income entitled to preferential tax treatment, Taxpayer accumulated tax deficiencies of $320,400 in 1979 and $636,700 in 1980.

II

The Commissioner argues that Treasury regulation § 1.861-8(e)(2) is clear on its face, and requires a taxpayer to allocate interest expense ratably to *all* income producing activities, including activities that produce income in the form of interest. As the Tax Court did in *Dresser,* we agree with the Commissioner.

The plain language of Treasury regulation § 1.861-8(e)(2) controls the outcome of this case. The Regulation provides that "interest expense is attributable to *all* activities and property regardless of any specific purposes for incurring an obligation on which interest is paid," 26 C.F.R. § 1.861-8(e)(2)(i) (emphasis added), and "the aggregate of deductions for interest shall be considered related to *all* income producing activities and properties of the taxpayer and, thus, allocable to *all* the gross income which the income producing activities and properties of the taxpayer generate," 26 C.F.R. § 1.861-8(e)(2)(ii) (emphasis added). Interest is plainly a form of income, and activities that produce interest are plainly income producing activities. Thus, the Regulation requires that the aggregate of deductions for interest be allocated ratably to interest income on the same basis as it is allocated to *all* other income producing activities. The plain language of the Regulation allows for no exception.[5]

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[5] The Commissioner also finds support for its position in the legislative history of § 994(a)(2). Taxpayer argues that this provision is ambiguous and does not help to resolve the issue of whether interest expense should be allocated first to interest income before the remaining interest expense is allocated to income from other income producing activities. We agree with Taxpayer.

Taxpayer would have us amend the language "all income producing activities" to "all income producing activities except those that produce income in the form of interest." As the Commissioner argues, "*all* income producing activities" includes all activities that use money to produce income, including income called "interest," "dividends," "rent," etc. "Interest" is nothing more than a label to describe income earned by putting money to work by selling its time value to others. Similarly, "dividend" is nothing more than a label to describe income earned by putting money to work by investing it in shares of stock. In the eyes of the law, there are important differences between debt and equity investments, but these differences are of no consequence for the purpose of Treasury regulation § 1.861-8(e)(2). What is of consequence is that both investments are income producing activities. That is, both involve the use of money to produce income, and the Regulation requires that deductions for interest expense be allocated to all income producing activities, with no distinction based on whether the income produced bears the label "interest" or "dividend" or any other appellation.

III

A

Taxpayer seizes upon an expression used in the Regulation—that "money is fungible"—to support its interpretation that the Regulation permits the allocation of interest expense first to interest income. This is ironic because the Regulation uses the concept that "money is fungible" to explain its mandate that interest expense be allocated to *all* income producing activities, and now Taxpayer wants us to use the same concept to amend the Regulation to create an exception to that very mandate. The Regulation uses the concept that "money is fungible" to explain why interest expense should be allocated across the board to all income producing activities:

> This approach [that money is fungible] recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. . . . When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.

26 C.F.R. § 1.861-8(e)(2)(i). Taxpayer extrapolates from the concept that money is fungible, the doctrine that "only *interest* [is] fungible." *See* Appellee's Br. at 19 n.19. According to Taxpayer, "these Regulations apply only to interest, and do not purport to make interest fungible with dividends, royalties, or any other form of income." *Id.* In other words, Taxpayer interprets the Regulation to mean that money paid in the form of interest expense is fungible only with money earned in the form of interest income, so the two sums must be balanced against each other to determine the amount of interest expense to be allocated to other forms of income. We find no support in the language of the Regulation for Taxpayer's argument. The Regulation says that *all* money is fungible, without exception for money that comes in as interest or goes out as interest, and uses this concept of fungibility to explain why interest expense must be allocated to all income producing activities. *See* 26 C.F.R. § 1.861-8(e)(2)(i). Taxpayer's tortured application of the principle that money is fungible does not justify amending the Regulation to provide an exception for interest income.

B

The only case Taxpayer relies on to support its position is *Dresser*, 911 F.2d at 1128.[6] In *Dresser*, the Fifth Circuit

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[6] *Dresser* arose under an earlier version of the regulations that was much less clear than the Regulation at issue here. While the Regulation

relies on its own judicial version of "economic reality" to justify the allocation of interest expense to interest income before any remaining interest expense is allocated to other income producing activities.

Dresser's version of "economic reality" posits that a business typically borrows money in a single transaction to finance its operations, even though some of the borrowed funds are not required for immediate use. *Id.* at 1135. To reduce the cost of holding these borrowed funds until they are actually needed, *Dresser* reasons, a business might invest in short-term, interest bearing instruments. *Id.* Thus, *Dresser* concludes, the "true cost of borrowing" to be allocated to all operations equals the interest expense on the debt incurred, reduced by any interest earned on the investment of any temporary cash surplus in interest bearing instruments. *Id.* at 1133, 1135.

Whatever might be said about *Dresser*'s theory of the "true cost of borrowing," it does not comport with the Regulation's concept that money is fungible. Taxpayer's reliance on *Dresser* is, therefore, misplaced. *Dresser* posits that interest expense is more related to interest income than it is to income by any other name. Yet, under the Regulation's concept that money is fungible, a cash surplus is simply available cash, and available cash from one income producing activity is interchangeable with cash from any other income producing activity. Indeed, cash positions may change daily, even hourly, as cash flows in from an array of sources, not just from interest bearing sources, and flows out to pay an array of expenses, not just interest expense. As the

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applicable to Bowater's case specifically states that interest expense "shall be considered related to *all* income producing activities," the regulation applicable in *Dresser* used the general language that "[f]rom the items of gross income . . . there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto." *See Dresser,* 911 F.2d at 1134 (quoting 26 C.F.R. § 1.861-8(a) (1975)).

Regulation recognizes, management has a great deal of flexibility as to the source and use of its available funds, 26 C.F.R. § 1.861-8(e)(2)(i), and the management of these funds is a complicated process which the Regulation does not reduce to a single linear cash flow.

The Regulation posits that "all activities and property require funds," *id.*, and that every business activity ties up money that could otherwise be used to reduce debt, and thereby reduce interest expense. In other words, the Regulation implicitly takes the approach that all income producing activities contribute to the cost of borrowing money simply by tying up funds, and that investment in interest bearing securities is no different from investment in other income producing activities, such as stocks, new plants and equipment, inventory, etc., in this respect. Thus, Taxpayer's—and *Dresser*'s—version of the "true cost of borrowing" has no basis in the Regulation.

In any event, the plain language of the Regulation does not give us the latitude to interpret it based on impressions of how businesses "typically" conduct their affairs, or on economic theories of what constitutes the "true cost of borrowing."

The Commissioner argues that we should decline to follow *Dresser* because we should give deference to the Internal Revenue Service's interpretation of the Regulation, as announced in an "Action on Decision" published in response to the Fifth Circuit's decision in *Dresser*. *See Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 510-12, 114 S.Ct. 2381, 2386, 129 L.Ed.2d 405 (1994). In that Action on Decision, the IRS expressly disagreed with *Dresser*, but noted that *Dresser* involved an earlier version of the regulations and stated its position that "section 1.861-8(e)(2) do[es] not provide for the netting of interest income and interest expense before allocation and apportionment." *In*

re: Dresser Ind., Inc., v. Commissioner, AOD 1991-011 (July 15, 1991). Taxpayer argues that we should not give deference to the IRS's interpretation because it amounts to no more than a self-serving litigating position. *See Bowen v. Georgetown University Hospital*, 488 U.S. 204, 213, 109 S.Ct. 468, 474, 102 L.Ed.2d 493 (1988). Because we believe the Commissioner's interpretation is supported by the plain language of the Regulation, we do not rely on a rule of deference.

IV

Taxpayer argues that the government's position would create an anomaly in the tax law between a business that borrows just enough funds to cover immediate needs, and a business that borrows funds to cover future needs while investing the cash surplus in the interim. *Dresser* makes no reference to such an anomaly, and Taxpayer offers no authority for its position. Under Taxpayer's characterization of the Commissioner's reading of the Regulation, the first business would be able to deduct less interest expense from its CTI than the second business would despite the fact that both businesses incur the same "actual interest cost." *See* Appellee's Br. at 20. This so-called anomaly rests on the premise that both businesses should be treated similarly because they incur the same "actual interest cost," defined as interest expense netted with interest income. Once again, Taxpayer's argument rests on a debatable economic theory rather than on the language of the Regulation.

In fact, we believe that Taxpayer's reading of the Regulation would itself create an anomaly between two otherwise identically situated DISCs and their related suppliers. Suppose DISC #1 invested its temporary cash surplus in interest bearing securities while DISC #2 invested in dividend paying stock. Under Taxpayer's approach, DISC #1 and its related supplier would allocate interest expense to

interest income prior to allocating the remaining "net interest expense" to the income earned from the sale of export property. Meanwhile, DISC #2 and its related supplier would allocate the interest expense, unreduced by interest income, to the income earned from the sale of export property as well as to the dividends earned from the stock investment. Taxpayer's approach of allocating interest expense would result in a higher CTI in the first DISC and its related supplier than in the second, solely because of the nature of the investment of the surplus funds. Yet as discussed above, the Regulation is clear on its face that for purposes of determining CTI, investment of surplus funds in activities that produce income called interest should be treated no differently from investment in activities that produce income called dividends. Taxpayer attempts to justify this anomaly by pointing to differences, *inter alia*, in the level of risk involved in stocks versus bonds.[7] We note, first, that the onetime conventional wisdom that bonds are less risky than stocks seems no longer valid in the age of volatile interest rates, as vividly illustrated by the recent savings and loan debacles and the Orange County bankruptcy. In any case, Taxpayer's cited distinctions are irrelevant because they do not change the core fact that income from both stocks and bonds qualifies as income from income producing activities. The distinctions between the two types of securities fail to justify a judicially created exception to the Regulation's clear mandate that interest expense be allocated to all income producing activities.

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[7] Taxpayer notes that (1) stock dividends, unlike interest payments, are not guaranteed as to payment or timing; (2) stock prices can fluctuate widely, even over short time intervals, while debt generally will not; and (3) debt generally must be paid in full before stockholders recover in the event of financial difficulty.

Taxpayer argues that temporary regulation § 1.861-9T(a), issued after the tax years at issue here, also supports its position. The temporary regulation amends the language of the Regulation that was in effect during the relevant tax years, adding the sentence, "The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year." 26 C.F.R. § 1.861-9T(a) (1996). The amendment was made prospective only. We agree with the Commissioner that the temporary regulation merely reiterates, or clarifies, the Regulation at issue here, and find no merit to Taxpayer's argument that the temporary regulation substantially changed the rules for the apportionment of interest expense.

CONCLUSION

We conclude that Treasury regulation § 1.861-8(e)(2) of the 1978 regulations does not permit Taxpayer to increase the CTI of its DISCs and their related suppliers under 26 U.S.C. § 994, and thereby increase the income of its DISCs, which is subject to preferential tax treatment, by allocating interest expense to interest income and allocating only the balance to all other income producing activities.

The decision of the Tax Court is REVERSED.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
UNITED STATES COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

GEORGE LANGE III
Clerk

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 3rd day of March, one thousand nine hundred and ninety-seven.

PRESENT: HON. Amalya L. Kearse
HON. Pierre N. Leval
HON. William A. Norris*
Circuit Judges

Docket No: 96-4039

BOWATER INC. AND SUBSIDIARIES,
formerly known as Bowater Holdings, Inc.,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

[stamp—Filed, MAR 3 - 1997, United States Court of Appeals, Second Circuit, George Lange III, Clerk]

Appeal from United States Tax Court.

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* Honorable William A. Norris, of the United States Court of Appeals for the Ninth Circuit, sitting by designation.

This cause came on to be heard on the transcript of record from the United States Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ORDERED, ADJUDGED, and DECREED that the judgment of said court be and it hereby is reversed in accordance with the opinion of this court.

For the Court
GEORGE LANGE III, Clerk

By: /s/ Beth J. Meador
Beth J. Meador
Administrative Attorney

[stamp—A TRUE COPY, GEORGE LANGE III, CLERK, /s/ George Lange III]

ISSUED AS MANDATE.
June 16, 1997 /init./ SM

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
UNITED STATES COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

GEORGE LANGE III
Clerk

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the Ninth day of June, one thousand nine hundred and ninety-seven.

Docket No.: 96-4039

Bowater, Inc. and Subsidiaries,
formerly known as Bowater Holdings, Inc.,
Petitioner-Appellee,

v.

Commissioner of Internal Revenue,
Respondent-Appellant.

[stamp—Filed, JUN 9 - 1997, United States Court of Appeals, Second Circuit, George Lange III, Clerk]

A petition for rehearing containing a suggestion that the action be *reheard in banc* having been filed herein by the petitioner *Bowater, Inc. and Subsidiaries,* and the panel that heard the appeal having filed an opinion on *March 3, 1997,*

IT IS HEREBY ORDERED that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges for the court in regular

active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT,
George Lange III, Clerk
By:

/s/ Beth J. Meador
Beth J. Meador,
Administrative Attorney

APPENDIX D

UNITED STATES TAX COURT

101 T.C. No. 14

BOWATER INCORPORATED, F.K.A. BOWATER HOLDINGS, INC., AND SUBSIDIARIES, Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 18436-91. Filed September 14, 1993.

Held, P may net interest income against interest expense in determining the amount of the interest deduction to be allocated and apportioned in computing combined taxable income for P and its DISC under sec. 994(a)(2), I.R.C. 1954. *Dresser Industries, Inc. v. Commissioner,* 911 F.2d 1128 (5th Cir. 1990), revg. on this issue 92 T.C. 1276 (1989), distinguished.

Robert T. Carney, Alex Edward Medovich, John N. Tsigakos, Ecton R. Manning, and *John B. Glendon*, for petitioner.

Stephen M. Miller and *Meryl Silver*, for respondent.

[-2-] COLVIN, *Judge*: Respondent determined deficiencies in petitioner's Federal income tax of $3,231,988 for 1976, $5,214,010 for 1979, and $27,096,396 for 1980.

The issue for decision is whether petitioner may net interest income against interest expense in determining the amount of the interest deduction to be allocated and apportioned in computing the combined taxable income (CTI) of petitioner and its domestic international sales corporations (DISC's). We hold that petitioner may.

As explained below, we distinguish *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), revg. on this issue 92 T.C. 1276 (1989), because a regulation (sec. 1.861-8(e)(2), Income Tax. Regs.) applies here that did not apply in *Dresser Industries*.

The parties submitted this issue for decision on a fully stipulated basis. Other issues in this case will be tried or otherwise resolved in due course. Section references are to the Internal Revenue Code in effect for the years at issue. Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

1. *Petitioner*

Bowater, Inc., F.K.A. Bowater Holdings, Inc., and Subsidiaries (petitioner), is a domestic corporation formed under the laws of Delaware. Petitioner's principal place of business was in Darien, Connecticut, when the petition was filed. During [-3-] petitioner's taxable years 1979 and 1980, its stock was wholly owned, directly or indirectly, by Bowater Corp., Ltd., a British corporation.

Petitioner and its subsidiaries filed consolidated Federal income tax returns for 1979 and 1980. Included in these returns were Bowater Southern Paper Corp. (Southern), and Bowater Carolina Corp. (Carolina). Carolina and Southern were wholly owned U.S. subsidiaries of petitioner.

2. *The Domestic International Sales Corporations*

Southern Export Corp. (Southern Export) was a wholly owned U.S. subsidiary of Southern. Carolina Export Co. (Carolina Export) was a wholly owned U.S. subsidiary of Carolina. Southern Export and Carolina Export qualified as DISC's throughout 1979 and 1980. They were accrual basis taxpayers and adopted fiscal years ending January 31. They

filed timely Federal income tax returns (Forms 1120-DISC) for their fiscal years ending in 1980 and 1981.

In 1979 and 1980, Southern Export and Carolina Export acted as commission agents for Southern and Carolina, respectively, in connection with the export sales of wood pulp and related products to customers outside of the United States and its possessions. Southern and Carolina computed the commissions paid to Southern Export and Carolina Export under the "50/50 combined taxable income" (CTI) method. Sec. 994(a)(2).

[-4-] In computing interest expense to be apportioned under sections 1.994-1(c)(6)(iii) and 1.861-8, Income Tax Regs., in the computation of the CTI of Southern and Carolina and their DISC's, petitioner allocated net interest expense (i.e., gross interest expense less gross interest income), as follows:

Amounts of Gross and Net Interest Expense

1979	*Carolina*	*Southern*
Gross interest expense	$1,036,575	$329,833
Gross interest income	932,151	184,627
Net Interest expense	104,424	145,206
1980		
Gross interest expense	1,332,345	544,906
Gross interest income	1,787,258	406,455
Net interest expense	(454,913)	138,451

The interest income of Southern and Carolina used to calculate net interest expense resulted primarily from the following procedure: sales proceeds from the sales of pulp and paper products sold by Carolina and Southern through their respective DISC's were collected by petitioner. Petitioner disbursed amounts to Carolina and Southern to cover their expenses. Petitioner retained the remainder for various

periods and treated it on the books of the respective companies as loans from Carolina and Southern to petitioner.[1]

[-5-] **OPINION**

1. *Background*

Congress enacted the DISC provisions (secs. 991-997) in 1971 to stimulate exports and to remove a tax disadvantage faced by U.S. firms exporting through domestic corporations. Revenue Act of 1971, Pub. L. 92-178, 85 Stat. 497; H. Rept. 92-533 (1971), 1972-1 C.B. 498, 502, 529; S. Rept. 92-437 (1971), 1972-1 C.B. 559, 565, 609. A qualifying DISC may defer part of the Federal tax on income from exports. However, the shareholders of a DISC are taxable currently on part of the profits and may generally defer taxation on the remaining part until the profits are withdrawn from the DISC or until the corporation ceases to qualify as a DISC. Secs. 995(a) and (b), 996(a)(1).

For a corporation to qualify as a DISC, at least 95 percent of its gross receipts must be qualified export receipts, and 95 percent of its assets must be qualified export assets. Secs. 992(a)(1), 993(a), (b), (f).

Section 994 provides intercompany pricing rules which are used to determine the price at which the parent corporation is deemed to have sold its products to the DISC. A DISC must use one of three intercompany pricing methods: (1) Four percent of qualified export receipts on the sale of export property; (2) 50 percent of the CTI of the DISC and

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[1] For purposes of this proceeding, the parties have stipulated that whether the retained amounts are bona fide loans is not an issue. Thus, we assume here that the loans have economic substance and were made on an arm's-length basis. We express no opinion about the result without this stipulation.

its supplier; or (3) the arm's-length price, computed in accordance with section 482. Sec. 994(a). The 50-percent method is at issue in this case. [-6-] Sec. 994(a)(2). It allows a DISC to earn taxable income of 50 percent of the CTI of a DISC and its supplier which is attributable to qualified export receipts derived from the sale by the DISC of export property plus 10 percent of export promotion expenses of the DISC attributable to those receipts.

2. *Treatment of Interest Expense for Computing CTI*

We must decide whether petitioner may net interest income against interest expense in determining the amount of interest deductions to be allocated and apportioned in computing the CTI of Southern, Carolina, and their DISC's. Petitioners have a larger CTI and a larger DISC tax benefit if they are permitted to net interest income against interest expense.

CTI is determined generally in accordance with the principles applicable under section 861. H. Rept. 92-533, *supra*, 1972-2 C.B. at 538. The legislative history provides:

> the combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country. These rules generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis. Thus, the combined taxable income of a DISC and a related person with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts the related person's cost of goods sold with respect to the property,

> the selling, overhead and administrative expenses of both the DISC and the related person which are directly related to the production or sale of the export property and a portion of the related person's and the DISC's expenses not allocable to any specific item of income, such portion to be determined on the basis of the ratio of the combined gross income from [-7-] the export property to the total gross income of the related person and the DISC. [Fn. ref. omitted.]

See also S. Rept. 92-437, *supra*, 1972-1 C.B. at 619. The Congressional reference to section 861 also appears in the DISC regulations:

> (iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8. Sec. 1.994-1(c)(6)(iii), Income Tax Regs.

3. *Fungibility of Money and Section 1.861-8(e)(2), Income Tax Regs.*

For purposes of section 861, interest is assumed to be fungible. Sec. 1.861-8(e)(2), Income Tax Regs. These regulations are based on the theory that all of a taxpayer's activities and assets need funds and that a taxpayer has great flexibility as to the source and use of funds. See Isenbergh, International Taxation, par. 6.8.1, at 205 (1990); Kuntz & Peroni, U.S. International Taxation, par. A2.05(5)(a), at A2-202 and 203 (1992). Section 1.861-8(e)(2), Income Tax Regs., was adopted on January 3, 1977, effective for taxable years beginning after December 31, 1976. It states:

(e) *Allocation and apportionment of certain deductions*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense * * *

(2) *Interest*—(i) *In general.* The method of allocation and apportionment for interest set forth [-8-] in this paragraph (e)(2) is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Normally, creditors of a taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. * * *

(ii) *Allocation of interest.* Except as provided in subdivisions (iii) and (iv) of this subparagraph, the aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate.

Both parties contend that this regulation applies here and that it favors their respective positions. At the same time, both parties recognize that this regulation does not expressly state whether or not netting of interest is allowed.

Dresser Industries, Inc. v. Commissioner, 911 F.2d 1128 (5th Cir. 1990), revg. on this issue *Dresser Industries, Inc. v. Commissioner*, 92 T.C. 1276 (1989), decided a form of this issue as it arose in an earlier year. That case is distinguishable because section 1.861-8(e)(2), Income Tax Regs., applies here, but did not apply to the years before the Court in *Dresser Industries*. *Dresser Industries* dealt with the taxpayer's taxable years 1976 and 1977, which began on November 1, 1975, and [-9-] November 1, 1976. *Dresser Industries, Inc. v. Commissioner*, 92 T.C. at 1276. Section 1.861-8(e)(2), Income Tax Regs., was first effective for taxable years beginning after 1976. Thus, it did not apply in that case. *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1134-1135. In contrast, the parties agree that the regulation applies here.

We believe petitioner's argument for netting interest expense and interest income is similar to the fungibility concept in the regulation because both focus on underlying economic realities. Netting of interest avoids unequal treatment of taxpayers with the same amount of actual interest cost, just as the fungibility of interest concept avoids unequal treatment of taxpayers whose indebtedness is structured differently.[2] As the Court of Appeals for the Fifth Circuit said in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1135:

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[2] In *St. Jude Medical Inc. v. Commissioner*, 97 T.C. 457, 481 (1991), we rejected the taxpayer's contention that we should decide the case based on economic reality. In that case, the taxpayer contended that sec. 1.861-8(e)(3), Income Tax Regs., was invalid and that it led to a result at odds with economic reality. That regulation did not apply a fungibility concept. In contrast, here, the regulation's fungibility approach suggests that consideration of economic reality should govern in deciding this case.

> Rarely, if ever, do the amount and timing of business borrowing directly correlate to specific investments. For instance, a business might borrow sufficient funds to finance its operations for the coming quarter. The business typically incurs the debt in a single transaction, even though its cash requirements are spread out over the ensuing three months. As a result, the business will have at least some borrowed funds on [-10-] hand that are not required immediately but which may be required in the near future. To reduce the cost of holding these funds until they are actually needed, the business might invest in short-term, interest bearing instruments. * * * Alternatively, a business might decide to finance its operations by issuing long-term bonds or other securities. Because it may be impractical to retire these obligations prior to their maturity, the business will typically invest any cash surplus to offset the cost of carrying its long-term debt. * * * In either case, the total *cost of the borrowing* is the interest expense on the debt incurred, reduced by the interest earned on the investment of any temporary cash surplus.

Respondent contends that interest income is not attributable to qualified export receipts. That contention is not persuasive because it assumes its own conclusion: that interest income should be considered separately, and not netted with interest expense.[3] Respondent's position of requiring alloca-

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[3] Even though sec. 1.861-8(e)(2), Income Tax Regs., did not apply to the years in *Dresser Industries, Inc. v. Commissioner*, 92 T.C. 1276 (1989), revd. on this issue 911 F.2d 128 (5th Cir. 1990), both the Tax Court and the Court of Appeals for the Fifth Circuit discussed it in dicta. Notwithstanding that discussion, the regulation was not effective for the years before the Court in *Dresser Industries*. In our opinion in *Dresser Industries*, we said that sec. 1.861-8(e)(2), Income Tax Regs., "does not provide for the netting of interest income and expense before allocation and apportionment." *Dresser Industries, Inc. v. Commissioner*, 92 T.C.

tion of gross interest expense would burden a DISC with a disproportionate [-11-] share of the actual borrowing costs of all operations. *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1136.

Respondent asserts that the only exception in the regulations to fungibility is stated in section 1.861-8(e)(2)(iv), Income Tax Regs., which does not apply here. Section 1.861-8(e)(2)(iv)(B), Income Tax Regs., provides in part:

> (B) Where an interest deduction is definitely related solely to specific property under (A) of this subdivision (iv), such interest deduction and such property, or the portion thereof, to which such interest deduction relates shall not be included in the allocation described in subdivision (ii) of this paragraph (e)(2). * * *

We agree that this provision applies only to interest expense allocable to specific property. However, regardless of this exception, we believe that netting is consistent with the fungibility approach taken in section 1.861-8(e)(2), Income Tax Regs. *Dresser Industries, Inc. v. Commissioner, supra* at 1135.

4. *Net Interest Expense Is the Actual Cost of Interest*

Net interest expense is the actual cost of borrowing; the total cost of borrowing is the interest expense on the debt incurred, reduced by the interest earned on the investment of

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at 1286. We did not discuss why the absence of a rule specifically related to netting should be construed to prohibit or allow netting. As discussed in this opinion, we conclude that, in the absence of a rule resolving the issue, netting is consistent with the fungibility concept in sec. 1.861-8(e)(2), Income Tax Regs., and with analogous precedents which allow netting, such as *General Portland Cement v. United States*, 628 F.2d 321 (5th Cir. 1980), and *Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. 352 (1984).

any temporary cash surplus. *General Portland Cement Co. v. United States*, 628 F.2d 321, 344 (5th Cir. 1980); *Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. 352, 402 (1984). The issue in those cases is analogous to the issue here. *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1133-1136, 92 T.C. at 1284. Section 613(a) provides a deduction for percentage [-12-] depletion limited to 50 percent of the taxpayer's taxable income from mining property. In computing taxable income, the taxpayer may reduce gross income by allowable deductions attributable to the mining process, including "financial overhead." Sec. 1.613-5(a), Income Tax Regs. In computing "financial overhead", the taxpayer may net interest expense and interest income. *General Portland Cement Co. v. United States, supra; Ideal Basic Industries, Inc. v. Commissioner, supra.* The Court of Appeals for the Fifth Circuit relied on these cases in reversing our decision in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1133-1136. In *General Portland Cement Co. v. United States, supra* at 344, the Court of Appeals reasoned:

> We think the purpose behind the "50% limit" argues in favor of the taxpayer in the instant case. We believe that purpose is served by subtracting the *actual* cost of interest, rather than an inflated amount. Taxpayer's actual cost of interest is its "net" interest expense.

The Court of Appeals relied on the fungibility concept as the underlying principle to decide that case. *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1135. These cases support petitioner's position because of the close logical relationship to the netting issue here.

Respondent argues that *General Portland Cement* is distinguishable because in it, unlike in this case, there was an investment of a temporary cash surplus from the borrowed funds. That basis for distinction is not persuasive in the

context of fungibility of interest. As noted earlier, respondent does not [-13-] dispute that the loans are bona fide.[4] We see no economic difference, and the parties point to none, among interest earned on the investment of surplus funds from short-term Treasury bills and commercial paper in *General Portland Cement Co. v. United States*, 628 F.2d at 343, short-term, highly liquid commercial paper in *Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. at 400, unspecified investments in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1130, and bona fide loans to related parties as in this case. In all of these situations net interest is the actual cost of borrowing.

We recognize that in other situations a taxpayer may not net interest income and expense. For example, in *Murphy v. Commissioner*, 92 T.C. 12, 14-15 (1989), a taxpayer who claimed the standard deduction was not allowed to net interest income and expenses because netting would circumvent the limitation of the deduction of personal interest to individuals who itemize their tax deductions. This consideration is not present in the percentage depletion or DISC contexts.

After disposition of the remaining issues in this case, decision will be entered under Rule 155. With respect to disposition of the remaining issues,

An appropriate order will be issued.

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[4] See *supra* note 1.

APPENDIX E

UNITED STATES TAX COURT

Docket No. 18436-91

BOWATER INCORPORATED (FORMERLY BOWATER HOLDINGS, INC.) AND SUBSIDIARIES

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinions of the Court filed April 10, 1995, and September 14, 1993, and incorporating herein the facts recited in the respondent's computation as the finding of the Court, it is

ORDERED and DECIDED:

That there is a deficiency in income tax due from the petitioner for the taxable year 1976 in the amount of $553,544; That there is a deficiency in withholding tax due from the petitioner for the taxable year 1979 in the amount of $119,368;

That there is a statutory deficiency in income tax, computed without allowance for business energy investment credit carryback, due from the petitioner for the taxable year 1979 in the amount of $2,845,151, and that there is an overpayment in income tax, computed after allowance for business energy investment credit carryback, for the taxable year 1979 in the amount of $1,250,000, which amount was paid on January 31, 1994 after the mailing of the notice of deficiency;

That there is a deficiency in withholding tax due from the petitioner for the taxable year 1980 in the amount of $152,717; and

That the following statement shows the petitioner's income tax liability for the taxable year 1980:

	1980
Tax Liability, computed without allowance for investment credit, job credit and research credit carrybacks from 1982 and 1983 to 1980	$ 26,176,766
Tax Assessed and Paid	2,350,646
Deficiency to be assessed, without allowance for investment, jobs and research credit carrybacks	$ 23,826,120
Reduction in liability due to investment, jobs and research credit carrybacks	20,008,389
Deficiency to be assessed, after allowance for investment, jobs, and research credit carrybacks	$ 3,817,731
Tax liability, computed without allowance for investment credit, jobs credit and research credit from 1982 to 1983 to 1980	$ 26,176,766
Net Tax Paid	4,200,646
Deficiency to be paid, without allowance for investment, jobs and research credit carrybacks	$ 21,976,120
Reduction in liability due to investment, jobs and research credit carrybacks	20,008,389
Deficiency to be paid, after allowance for investment, jobs and research credit carrybacks	$ 1,967,731

Entered: DEC 4 1995

(Signed) ARNOLD RAUM
Judge

It is hereby stipulated that the foregoing decision is in accordance with the opinions of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

STUART L. BROWN
CHIEF COUNSEL
INTERNAL REVENUE SERVICE

/s/ Robert T. Carney
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APPENDIX F

STATUTES AND REGULATIONS

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 861. Income From Sources Within the United States

[Sec. 861(a)]

(a) Gross Income From Sources Within United States.—

* * *

(b) Taxable Income From Sources Within United States.—From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. In the case of an individual who does not itemize deductions, an amount equal to the standard deduction shall be considered a deduction which cannot definitely be allocated to some item or class of gross income.

Sec. 994. Inter-company pricing rules

(a) In general.—In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482). . . .

Treasury Regulations on Income Tax (26 C.F.R.) (1978):

Reg. § 1.861-8 Computation of Taxable Income From Sources Within the United States and From Other Sources and Activities.

(a) *In general.*—

(1) *Scope.* Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as "deductions") of the taxpayer. . . .

(2) *Allocation and apportionment of deductions in general.* A taxpayer to which this section applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income

between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(2) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. . . .

(3) *Class of gross income.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61 . . . .

* * *

(5) *Effective Date.* The provisions of this section shall be applicable to taxable years beginning after December 31, 1976. . . .

(b) *Allocation.*

(1) *In general.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. . . . Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income. . . . Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are

related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. . . .

* * *

(4) *Deductions related to a class of gross income.* See paragraph (e) of this section for rules related to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) for rules relating to the apportionment of deductions.

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. . . .

Paragraphs (e)(2) through (e)(8) of this section provide the applicable rules for allocation and apportionment of deductions for interest, research, and development expenses, and certain other deductions. . . .

* * *

(e) *Allocation and apportionment of certain deductions*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. . . .

(2) *Interest*—(i) *In general.* The method of allocation and apportionment for interest set forth in this paragraph (e)(2) is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific pur-

poses for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Normally, creditors of a taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.

(ii) *Allocation of interest.* Except as provided in subdivisions (iii) and (iv) of this subparagraph, the aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate.

* * *

(v) *Apportionment of interest—asset method.* Normally, the deduction for interest expense relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore the deduction for interest should normally be apportioned on the basis of asset values. Indebtedness permits the taxpayer to acquire or retain different kinds of assets which may produce substantially different yields of gross income in relation to their value. Thus, apportionment of an interest deduction on such basis as gross income may not be reasonable. If a taxpayer consistently apportions the deduction for interest on

the basis of the tax book value (original cost for tax purposes less depreciation allowed for tax purposes) of its assets, that method will ordinarily be accepted. Alternatively, if a taxpayer can apportion the deduction on the basis of the fair market value of his assets and he can establish the fair market value to the satisfaction of the Commissioner, that method will also be acceptable. However, once the taxpayer uses fair market value the taxpayer must continue to use such method unless expressly authorized by the Commissioner to change his method.

* * *

(f) *Miscellaneous matters*—(1) *Operative sections.* The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below. . . .

* * *

(iii) *DISC taxable income.* Section 994 provides rules for determining the taxable income of a DISC with respect to qualified sales and leases of export property and qualified services. The "50-50" combined taxable income method available for making such determination provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from such sales and leases of export property and such services. . . .

* * *

Reg. § 1.994-1 Inter-Company Pricing Rules for DISC'S.

* * *

(c) *Transfer price for sales of export property.*

(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in a case of a sale of export property described in paragraph (b)(1) of this section.

* * *

(3) *The "50-50" combined taxable income method.* Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in subparagraph (f) of this section) of the DISC attributable to such qualified export receipts.

* * *

(6) *Combined taxable income.* For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which related to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) all adjustments required by section 482 with respect to transactions to which such section is applicable. In determining

the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

* * *

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in Treas. Reg. § 1.861-8.

* * *

APPENDIX G

SUPREME COURT OF THE UNITED STATES
OFFICE OF THE CLERK
WASHINGTON, DC 20543-0001

William K. Suter
Clerk of the Court

Area Code 202
479-3011

August 26, 1997

Mr. Albert G. Lauber Jr.
Caplin & Drysdale, Chtd.
#1100, One Thomas Circle, N.W.
Washington, DC 20005

Re: Bowater, Inc. and Subsidiaries
v. Commissioner of Internal Revenue
Application No. A-157

Dear Mr. Lauber:

The Application for an extension of time within which to file a petition for a writ of certiorari in the above-entitled case has been presented to Justice Ginsburg, who on August 26, 1997, extended the time to and including October 7, 1997.

This letter has been sent to those designated on the attached notification list.

Sincerely,

William K. Suter, Clerk

By /s/
Melissa A. Blalock
Assistant Clerk

SUPREME COURT OF THE UNITED STATES
OFFICE OF THE CLERK
WASHINGTON, DC 20543-0001

William K. Suter
Clerk of the Court

Area Code 202
479-3011

NOTIFICATION LIST

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Clerk
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the Second Circuit
1702 US Courthouse, Foley Sq.
New York, NY 10007

(2)

Supreme Court, U.S.
FILED
NOV 3
CLERK

No. 97-603

IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

BOWATER INCORPORATED AND SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF *AMICUS CURIAE* NATIONAL FOREIGN TRADE COUNCIL, INC. IN SUPPORT OF PETITIONER'S REQUEST FOR WRIT OF CERTIORARI

FRED F. MURRAY
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November 3, 1997

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11 pp

QUESTION PRESENTED

Whether the interest expense to be allocated and apportioned, pursuant to Treasury Regulation § 1.861-8(e), is net interest expense (that is, gross interest expense minus offsetting interest income).

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

No. 97-603

BOWATER INCORPORATED AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

---

BRIEF OF *AMICUS CURIAE* NATIONAL FOREIGN TRADE COUNCIL, INC. IN SUPPORT OF PETITIONER'S REQUEST FOR WRIT OF CERTIORARI

STATEMENT OF INTEREST

The National Foreign Trade Council, Inc. ("NFTC") is a New York not-for-profit corporation with more than 550 member firms concerned with international trade and investment.[1] Interests of NFTC members account for over seventy percent of all United States exports and direct private investment abroad.

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[1] Counsel for amicus curiae and others, other than counsel for a party, authored this brief. No other person or entity other than amicus curiae and its members made monetary contributions for the preparation and submission of the brief.

The NFTC has a strong interest in the Court's resolution of this case because the Second Circuit Court of Appeals in this case, and the Fifth Circuit Court of Appeals in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), are in direct conflict on the issue of whether, pursuant to Treas. Reg. § 861, interest expense is to be allocated after having first been reduced by interest income (thus, allocating net interest expense). The Court's answer to this question will impact all of NFTC's member companies.

Counsel for the parties have consented to the filing of this brief in letters filed with the Clerk of the Court.

STATEMENT OF THE CASE AND FACTS

Amicus adopts the statement of the case and facts as set forth by Petitioner.

REASONS FOR GRANTING THE PETITION

The Second Circuit's decision in this case, hereafter also referred to as *Bowater* and reported at 108 F.3d 12 (1997), directly conflicts with the Fifth Circuit's decision in *Dresser Industries, Inc. v. Commissioner,* 911 F.2d 1128 (5th Cir. 1990), on the issue of allocation of interest expense under Treas. Reg. § 1.861-8 (the "§ 861 Regulations"), when determining certain foreign source income of a Domestic International Sales Corporation ("DISC"). The Second Circuit held that the § 861 Regulations require the allocation of gross interest expense, whereas the Fifth Circuit held that interest income first reduces interest expense, resulting in an allocation of net interest expense.

The § 861 Regulations are used extensively in the foreign tax area to calculate limitations under a wide variety of Internal Revenue Code sections. The interpretation of these

regulations should be uniform so that all United States based multinational companies are on an even playing field.

In *Dresser,* the Fifth Circuit noted that the § 861 Regulations set out the *method* of allocating interest expense, but not the *amount* of interest expense that must be allocated.[2] *Dresser,* 911 F.2d at 1135. The concept that money is fungible underlies the regulation. Applying the fungibility concept, the Fifth Circuit determined that the interest to be allocated should represent the "actual cost of financing," which is best represented by *net* interest expense.

In *Bowater,* however, the Second Circuit reasoned that if interest expense is to be allocated to all income producing activities, then it should be allocated against interest income on the same basis as it is allocated to other types of income, and not first be specifically allocated to interest income.

The issue of netting interest income against interest expense was first addressed in *General Portland Cement Co. v. U.S.*, 628 F.2d 321 (5th Cir. 1980), *cert. denied*, 450 U.S. 983 (1981), and again a few years later in *Ideal Basic*

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[2] Dresser involved the pre-1977 regulations, which differ slightly from the version of the Regulations at issue in *Bowater.* However, the *Dresser* and *Bowater* holdings differ based on the court's interpretation of the underlying purpose of the regulations, and not because of any slight wording changes in the regulations. The regulations under *Dresser* read as follows:

> From the items of gross income specified in §§ 1.861-2 to 1.361-7, inclusive, as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income.

Treas. Reg. § 1.861-8(a) (as amended in 1975).

Industries, Inc. v. Commissioner, 82 T.C. 352 (1984). Those cases involved the calculation of a depletion allowance which was limited to 50% of taxable income from a producing property. A portion of the corporation's interest expense had to be allocated against extraction income to determine the 50% limitation.

In *General Portland*, the Fifth Circuit determined that the purpose behind the 50% limitation was best served "by subtracting the *actual* cost of interest, rather than an inflated amount. Taxpayer's actual cost of interest is its 'net' interest expense." *General Portland Cement*, 628 F.2d at 344; quoted in *Ideal Basic*, 82 T.C. at 402. The Internal Revenue Service acquiesced in both decisions, acknowledging that "the effective amount of interest available to a taxpayer as a deduction for income tax purposes is the net cost of borrowing the money and not the higher book amount which fails to take into account the fact that the borrowed money has been reinvested." *See* IRS Action on Decisions 1986-022 and 1986-023 (Feb 26, 1986).

The logic of *General Portland* and *Ideal Basic* was cited with approval in *Dresser*, 911 F.2d at 1134, with regard to the § 861 Regulations. The Fifth Circuit noted that the objective of both the depletion provisions and the § 861 Regulations was to apportion among related business operations the "actual cost of borrowing," which requires allocating the net interest expense. *Dresser,* 911 F.2d at 1135-1136. The *Dresser* decision was followed by the Tax Court opinion in this case, 101 T.C. 207, 212, 214 (1993), *The Coca-Cola Company v. Commissioner,* 106 T.C. 1,4,31 (1996), and *Computervision Int'l Corp. v. Commissioner*, 71 T.C.M.(CCH) 2450, 2465 (1996).

Therefore, the Second Circuit's *Bowater* decision, which disallows interest netting, is in direct conflict with this line of cases.

The § 861 Regulations are pervasive in the foreign tax arena, and are used when calculating various types of foreign income, losses or limitations, and not just for the combined taxable income of a DISC and related party. While it is true that, in September 1988, Treasury issued new, temporary regulations relating to the allocation and apportionment of various expenses that appear on their face to be at odds with the pre-1988 regulations (*see* Treas. Reg. § 1.861-9T(a), 53 Fed. Reg. 35647 (1988), the NFTC agrees with the Second Circuit's conclusion (and the Respondent's corresponding analysis of the temporary regulations in that forum, Brief of the United States at 11) "that the temporary regulation merely reiterates, or clarifies, the Regulation at issue here" and does not change the rules for apportionment of interest expense. *See* 108 F.3d at 17. Rather, these regulations confirm the validity of the fungibility concept of money that was first specifically espoused in the post-1977 regulations. Thus, the NFTC believes the question presented in this case has continuing significance.

Virtually every company doing business internationally must calculate foreign source income under Treas. Reg. § 1.863-1(c), the overall limitation on the foreign tax credit under Treas. Reg. § 1.904-1(b)(1), and various foreign tax credit basket limitations under Treas. Reg. § 1.904-4(c)(2), all of which cross-reference to the § 861 Regulations. The foreign tax credit can also be affected by the "look-through" rules, which implicate the § 861 Regulations. Treas. Reg. § 1.904-5(c)(2)(ii). If a taxpayer is an oil company, it must use the § 861 Regulations to determine whether interest received from a foreign corporation is foreign oil related income under

Treas. Reg. § 1.907(c)-2(d)(2). If a taxpayer had net foreign losses, it must use the § 861 Regulations to calculate its overall foreign loss limitations under Treas. Reg. § 1.904(f)-1(c)(3). Controlled foreign corporations must use the § 861 Regulations to determine foreign base company income for subpart F purposes. Treas. Reg. § 1.954-1(c)(i).

Therefore, the issue of how to calculate the above-listed limitations, and whether foreign source income should be reduced by an allocation of gross or net interest expense, is of great importance to every U.S. company that does business overseas. Among other things, the § 861 Regulations determine how much of their foreign taxes are creditable, and can directly impact their competitiveness in the world market.

Further, multinational corporations should not have to face different results in the interpretation of the § 861 Regulations depending upon where they reside. A taxpayer located in the Second Circuit may not net interest income against interest expense. A taxpayer in any other circuit would have substantial authority to "net". Thus, the Court's review of this case would serve judicial economy by avoiding further litigation of this issue.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1997

BOWATER INCORPORATED AND SUBSIDIARIES,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, under the terms of the regulation that applied during the tax years involved in this case (26 C.F.R. 1.861-8 (1980)), interest income was to be netted against interest expense before allocating interest costs proportionally against the income of a domestic international sales corporation.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-12a) is reported at 108 F.3d 12. The opinion of the Tax Court (Pet. App. 17a-28a) is reported at 101 T.C. 207.

JURISDICTION

The judgment of the court of appeals (Pet. App. 13a-14a) was entered on March 3, 1997. A petition for rehearing was denied on June 9, 1997 (Pet. App. 15a-16a). On August 26, 1997, Justice Ginsburg extended the time within which to file a petition for a writ of certiorari to and including October 7, 1997 (Pet. App. 40a). The petition for a writ of certiorari was filed on October 3, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. During the years involved in this case, Congress provided special tax benefits to "domestic international sales corporations" (DISCs) in an effort to stimulate the export of goods manufactured in the United States and to encourage the export of these goods through domestic rather than foreign affiliates. 26 U.S.C. 991-997. The key feature of this legislative scheme was that these corporations were not directly subject to federal income taxes. 26 U.S.C 991; see 26 U.S.C. 992(a). The income received by these entities was instead allocated and taxed to their shareholders. A portion of the income was taxed as a constructive dividend when the income was earned. The remainder was taxed when it was distributed to the shareholders of the DISC, when the shareholders disposed of their DISC stock or when the DISC lost its exempt status. 26 U.S.C. 995(b), (c).[1]

This case concerns one of the special intercompany pricing rules for DISC entities contained in Section 994 of the Internal Revenue Code, 26 U.S.C. 994. These intercompany pricing rules governed the allocation of the profit from export transactions between

---

[1] In 1984, the DISC provisions were supplanted for most entitites by the foreign sales corporation (FSC) rules (26 U.S.C. 921-927) that were enacted as part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 985-1003. The FSC rules were enacted in response to complaints from our international trading partners that the DISC system represented an illegal export subsidy in violation of the General Agreement on Tariffs and Trade. See S. Rep. No. 169, 98th Cong., 2d Sess. 634-635 (1984). When the FSC rules were enacted, Congress exempted from tax DISC income that had been accumulated through December 31, 1984. § 805(b)(2)(A), 98 Stat. 1001.

the domestic producer and its related DISC. The rules permitted a greater allocation of profits to the DISC than would ordinarily result from arm's length pricing. Because a portion of a DISC's income was deferred from tax under the statute, the effect of these favorable pricing rules was to increase the amount of taxes deferred and, therefore, the resulting tax benefit.

This case involves the "50/50 combined taxable income" pricing rule in Section 994(a)(2) of the Code (Pet. App. 4a). Under this pricing rule, the deemed transfer price from the domestic producer to the DISC for the sale of export property was the price that would allow the DISC to derive taxable income from the sale equal to (i) 50 percent of the combined taxable income of the DISC and its related supplier attributable to the sale plus (ii) 10 percent of the export promotion expenses attributable to the sale. 26 U.S.C. 994(a)(2). Treasury regulations issued under the statute to implement this pricing rule provided that "the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts * * * of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts" (26 C.F.R. 1.994-1(c)(6)). The regulations further provided that, in determining the total costs of the DISC and its related supplier relating to the sale of export property, the costs (other than the cost of goods sold) related to such gross receipts were to be "determined in a manner consistent with the rules set forth in [26 C.F.R.] § 1.861-8" (26 C.F.R. 1.994-1(c)(6)(iii)).[2]

---

[2] The intercompany pricing method involved in this case is also used to compute FSC income. See note 1, *supra*; 26

The "rules set forth in [26 C.F.R.] § 1.861-8"—which thus governed the allocation of items of expense and income in determining the income of a DISC—have been issued in three different versions. See pages 12-16, *infra*; note 2, *supra*. This case involves the proper application of the *second* of the three versions of these rules—the version that was in effect between 1976 and 1986—to the business operations of petitioner during the 1979 and 1980 tax years.

2. Petitioner is a domestic corporation that produces wood pulp and other related products (Pet. App. 3a). During 1979 and 1980, petitioner owned two subsidiaries—Bowater Southern Paper Corporation (Southern) and Bowater Carolina Corporation (Carolina). These subsidiaries, in turn, each owned a DISC for which they were the "related supplier" (*id.* at 3a-4a).

In 1979 and 1980, petitioner filed consolidated federal income tax returns with the members of its affiliated group, which included Southern and Carolina and their DISCs (Pet. App. 4a, 18a). See 26 U.S.C. 1504. In these returns, petitioner computed the combined taxable income of each DISC and its related supplier by first offsetting their gross interest income against their gross interest expense

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U.S.C. 925(a)(2). For taxable years beginning after December 31, 1986, however, and thus for most of the years in which a calculation of FSC income would occur, the allocation of interest expenses for both DISC and FSC purposes is determined under a different version of 26 C.F.R. 1.861-8. *Compare* 26 C.F.R. 1.994-1(c)(6)(iii) (1980) *with* 26 C.F.R. 1.925(a)-1T(c)(6)(iii)(D). See T.D. 8228, 1988-2 C.B. 136, 144; Pet. App. 12a.

and then allocating the resulting combined net interest expense against their other income producing activities, including their receipts from the sale of export property (Pet. App. 4a).

On audit, the Commissioner determined that petitioner's method of calculating combined taxable income was incorrect and, as a consequence, that petitioner had deficiencies in income tax of $320,400 for 1979 and $686,700 for 1980 (Pet. App. 4a-5a). In the Commissioner's view, the proper method for computing combined taxable income under the controlling regulation was to allocate the gross interest expense of these entities equally against all of their income producing activities (*ibid.*). It was not, as petitioner had done, to net gross interest expense against gross interest income first, and only then to allocate the net interest expense to the remaining income producing activities (*ibid.*).

3. The case was presented to the Tax Court on a set of stipulated facts (Pet. App. 18a). The Tax Court concluded that petitioner had correctly calculated the combined taxable income of its DISCs and related suppliers by first netting their gross interest income against their gross interest expense and then allocating the resulting net interest expense to the entities based upon their gross receipts from other business activities, such as sales of export products (*id.* at 21a-28a).

4. The court of appeals reversed (Pet. App. 1a-12a). The court held that the plain language of the applicable regulations required that gross interest expense, not net interest expense, be allocated against the gross income produced by the DISCs and

their related suppliers (*id.* at 5a). The court of appeals explained (*ibid.*):

> The Commissioner argues that Treasury regulation § 1.861-8(e)(2) is clear on its face, and requires a taxpayer to allocate interest expense ratably to *all* income producing activities, including activities that produce income in the form of interest. * * * [W]e agree with the Commissioner.
>
> The plain language of Treasury regulation § 1.861-8(e)(2) controls the outcome of this case. The Regulation provides that "interest expense is attributable to *all* activities and property regardless of any specific purposes for incurring an obligation on which interest is paid," 26 C.F.R. § 1.861-8(e)(2)(i) (emphasis added), and "the aggregate of deductions for interest shall be considered related to *all* income producing activities and properties of the taxpayer and, thus, allocable to *all* the gross income which the income producing activities and properties of the taxpayer generate," 26 C.F.R. § 1.861-8(e)(2)(ii) (emphasis added). Interest is plainly a form of income, and activities that produce interest are plainly income producing activities. Thus, the Regulation requires that the aggregate of deductions for interest be allocated ratably to interest income on the same basis as it is allocated to *all* other income producing activities. The plain language of the Regulation allows for no exception.

The court of appeals further stated that, "under the Regulation's concept that money is fungible, a cash surplus is simply available cash, and available cash from one income producing activity is interchange-

able with cash from any other income producing activity" (Pet. App. at 8a). The court noted that "the Regulation implicitly takes the approach that all income producing activities contribute to the cost of borrowing money simply by tying up funds, and that investment in interest bearing securities is no different from investment in other income producing activities, such as stocks, new plants and equipment, inventory, etc., in this respect" (*id.* at 9a).

In concluding that the plain text of the regulation requires gross interest expense to be allocated equally to "all" income producing activities (rather than be charged first against gross interest income), the court of appeals criticized the decision of the Fifth Circuit in *Dresser Industries, Inc.* v. *Commissioner*, 911 F.2d 1128 (1990). In *Dresser*, the court had relied on what it asserted was "economic reality" in concluding that an earlier and different version of the Treasury regulation had permitted interest expense to be allocated first against interest income. *Id.* at 1135. In the present case, the court noted that the text of the regulation had been revised and clarified to require the conclusion reached in this case (Pet. App. 7a-8a n.6). The court further observed, however, that the concept of "economic reality" contained in *Dresser* was misguided because "it does not comport with the Regulation's concept that money is fungible" (*id.* at 8a):

> *Dresser* posits that interest expense is more related to interest income than it is to income by any other name. Yet, under the Regulation's concept that money is fungible, a cash surplus is simply available cash, and available cash from one

income producing activity is interchangeable with cash from any other income producing activity.

The court of appeals also rejected petitioner's contention that a *third* and more recent version of this same regulation (26 C.F.R. 1.861-9T(a)), which applies to all tax years beginning after December 31, 1986, "substantially changed the rules for the apportionment of interest expense by providing that '[t]he term interest refers to the gross amount of interest expense incurred by a taxpayer in a given year'" (Pet. App. 12a). The court of appeals agreed with the Commissioner that this third and most recent version of the regulation "merely reiterates, or clarifies," the requirements already contained in the second version of the regulation—the version that was at issue in this case (*ibid.*).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Moreover, in an amendment effective since 1987, the applicable regulation was revised expressly to require the very result reached by the court of appeals under the earlier version of the regulation involved in this case. Further review is therefore not warranted.

1. The decision of the court of appeals is correct for the reasons explained at length in the court's decision. As in effect during the years involved in this case, Section 1.861-8 of the Treasury Regulations established rules for allocating "expenses, losses, and other deductions" for various purposes under the Internal Revenue Code. 26 C.F.R. 1.861-8(a)(1), (f) (1980). The plain text of that regulation specified that "interest expense is attributable to

all activities and property regardless of any specific purposes for incurring an obligation on which interest is paid" (26 C.F.R. 1.861-8(e)(2)(i) (1980) (emphasis added)) and that "the aggregate of deductions for interest shall be considered related to *all* income producing activities and properties of the taxpayer and, thus, *allocable to all the gross income* which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate." 26 C.F.R. 1.861-8(e)(2)(ii) (1980) (emphasis added).

As the court of appeals concluded, under the "plain language" of this regulation, interest expense must "be allocated ratably to interest income on the same basis as it is allocated to *all* other income producing activities" (Pet. App. 5a). The court of appeals thus correctly held that the allocation procedure advocated by petitioner—which would allocate interest expense first against interest income—is prohibited by the plain requirement of the regulation that interest expense be allocated ratably to "all" of the income producing activities of the taxpayer.

2. In an attempt to evade this "plain language" of the regulation, petitioner engages in a selective reading of its provisions. Subparagraph (e)(2)(i) of the regulation (entitled "In general") provides an overview for the more specific subparagraphs of 26 C.F.R. 1.861-8(e)(2) that establish the precise rules for allocating interest expense. The "general" overview provision states that the "allocation and apportionment for interest * * * is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring the

obligation on which the interest is paid." 26 C.F.R. 1.861-8(e)(2)(i) (1980). The specific provision entitled "Allocation of interest" (26 C.F.R. 1.861-8(e)(2)(ii) (1980)) provided the concrete governing rule by specifying that "interest shall be considered related to all income producing activities" (*ibid.*).

In arguing that the court erred in this case, petitioner ignores the specific provisions of the regulation that establish the proper procedure for "[a]llocation of interest" (26 C.F.R. 1.861-8(e)(2)(ii) (1980)) and instead relies solely on the three words "money is fungible" contained in the "general" introductory subsection of the regulation (Pet. 8-12). It is obviously telling that petitioner fails to discuss—or even to acknowledge the existence of—the "plain language" of the specific, governing provisions of the regulation on which the court of appeals relied. Moreover, as the court of appeals explained in detail, it is the very fact that "money is fungible" that explains *why* the regulation requires interest costs "to be allocated accross the board to all income producing activities" (Pet. App. 6a, 7a):[3]

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[3] The requirement that gross interest expenses be allocated to "all" income producing activities is based on the fact that "money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring the obligation on which the interest is paid." 26 C.F.R. 1.861-8(e)(2)(i). As the court of appeals emphasized (Pet. App. 8a):

> under the Regulation's concept that money is fungible, a cash surplus is simply available cash, and available cash from one income producing activity is interchangeable with cash from another income producing activity.

Petitioner's contrary speculations about "business realities and common sense" (Pet. 11)—which the court of appeals politely

> The regulation says that *all* money is fungible, without exception for money that comes in as interest or goes out as interest, and uses this concept of fungibility to explain why interest expenses must be allocated to all income producing activities. See 26 C.F.R. § 1.861-8(e)(2)(i). Taxpayer's tortured application of the principle that money is fungible does not justify amending the Regulation to provide an exception for interest income.

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referred to as "debatable economic theory" (Pet. App. 10a)—do not support petitioner's efforts to nullify the "plain language" of the 1977 version of the regulation (*id.* at 5a). Moreover, as the court of appeals emphasized, if petitioner's two-tiered allocation theory were accepted, similarly situated taxpayers would be treated differently under the regulation (*id.* at 10a-11a):

> Suppose DISC #1 invested its temporary cash surplus in interest bearing securities while DISC #2 invested in dividend paying stock. Under taxpayer's approach, DISC #1 and its related supplier would allocate interest expenses to interest income prior to allocating the remaining "net interest expense" to the income earned from the sale of export property. Meanwhile, DISC #2 and its related supplier would allocate the interest expense, unreduced by interest income, to the income earned from the sale of export property as well as to the dividends earned from the stock investment. Taxpayer's approach of allocating interest expense would result in a higher [combined taxable income] in the first DISC and its related supplier than in the second, solely because of the nature of the investment of the surplus funds.

The court of appeals properly concluded that there is no basis for a "judicially created exception to the Regulation's clear mandate that interest expense be allocated to all income producing activities" (*id.* at 11a).

Indeed, as the Treasury explained in 1988, it is "[b]ecause money is considered to be fungible [that] interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid." T.D. 8228, 1988-2 C.B. 137.

3. a. Three different versions of this regulation have been in force at various times. Prior to 1976, the first version of the regulation did not expressly require interest expense to be allocated among "all" income producing activities. See Pet. App. 7a-8a n.6. Under that early version of the regulation, the Fifth Circuit held in *Dresser Industries, Inc.* v. *Commissioner*, 911 F.2d at 1135, that interest expense should first be netted against interest income and that only the resulting net interest expense should then be allocated to other income-producing activities.

b. In 1977, however, the regulation was amended to specify that interest expense was to be allocated among "all" income producing activities. 26 C.F.R. 1.861-8(e)(2)(i), (ii) (1980). In *Dresser*, which involved the *first* version of the regulation, the court noted that the regulation had been thus "substantially revised" in 1977. 911 F.2d at 1134 n.11. Because that case involved taxes due for years before the regulation was amended, however, the court concluded in *Dresser* that "[w]e need not and do not address the question whether interest netting is consistent with the [1977] version of the Treasury Regulations" (*ibid.*).

The present case, by contrast, involves the provisions of the regulation as amended in 1977. In following the "plain language" of the amended version of the regulation, the court of appeals noted in the

present case that "*Dresser* arose under an earlier version of the Regulations that was much less clear" (Pet. App. 7a n.6).[4] The court in *Dresser* emphasized that it "need not" and would not address the question whether interest netting is permitted under the 1977 version of the regulation that is involved in the present case.[5] The question that the court in *Dresser*

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[4] Petitioner asserts, without any supporting analysis, that there is "no meaningful difference" between the first two versions of the regulation (Pet. 8). In making that assertion, petitioner fails to acknowledge the existence and content of subparagraph (e)(2)(ii) of the regulation, which specifies that "interest shall be considered related to all income producing activities and properties of the taxpayer." 26 C.F.R. 1.861-8(e)(2)(ii). As the court of appeals emphasized, this language did not exist in the "earlier version of the regulations that was much less clear" that was involved in the *Dresser* case (Pet. App. 7a n.6). Petitioner simply ignores this obvious and highly pertinent distinction in the text of the two regulations.

The Fifth Circuit emphasized in *Dresser* that the 1977 version of 26 C.F.R. 1.861-8 was not "controlling" in that case. 911 F.2d at 1135. The court nonetheless suggested that the reference in the 1977 version of the regulation to the fungibility of money was consistent with its decision under the prior regulation. *Ibid.* In making that statement in dicta, however, the Fifth Circuit gave no consideration to the "plain text" of subparagraph (e)(2)(ii) of the 1977 regulation, which was controlling in this case (Pet. App. 5a).

[5] Similarly, neither the decision of the Fifth Circuit in *General Portland Cement Co.* v. *United States*, 628 F.2d 321, 343-344 (1980), cert. denied, 450 U.S. 983 (1981), nor the decision of the Tax Court in *Ideal Basic Industries, Inc.* v. *Commissioner*, 82 T.C. 352, 401-402 (1984), which petitioner cites (Pet. 10), is relevant to the proper interpetation of the regulation involved in this case. Each of those cases presented the question whether gross interest expense or net interest expense should be used in determining the taxable income from depletion property for purposes of the limitation on the per-

stated that it "need not" answer is precisely the question that the court addressed and answered in this case. The suggestion that petitioner now makes that the decision in *Dresser* "directly conflicts" (Pet. 8) with the decision in this case is thus plainly incorrect.

Indeed, the present case is the only appellate decision that has analyzed the governing language of the 1977 version of the regulation.[6] There is obviously no conflict among the courts of appeals as to the meaning of the "plain language" (Pet. App. 5a) of 26 C.F.R. 1.861-8(e)(2)(ii) (1980), for no other court of appeals has addressed and interpreted that provision. See note 4, *supra*.

c. Moreover, as the court of appeals noted (Pet. App. 12a), a *third* version of this same regulation was adopted in 1987. That 1987 version replaced the 1977 version involved in this case. For all tax years beginning after December 31, 1986, the new regulation issued in 1987—rather than the 1977 regulation involved in this case or the pre-1977 regulation that was involved in *Dresser*—is controlling. The 1987 version of the regulation contains language that

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centage depletion deduction in Section 613 of the Internal Revenue Code, 26 U.S.C. 613. Neither of those decisions involved the regulation at issue in this case, which requires interest to be allocated to "all" of the taxpayer's income producing activities. 26 C.F.R. 1.861-8(e)(2)(i), (ii) (1980).

[6] The opinions of the Tax Court that have adopted the Fifth Circuit's opinion in *Dresser* (*Coca-Cola Co.* v. *Commissioner*, 106 T.C. 1 (1996); *Bowater Inc.* v. *Commissioner*, 101 T.C. 207 (1993); *Computervision Int'l Corp.* v. *Commissioner*, 71 T.C.M. (CCH) 2450 (1996)) have not considered the governing text of the amended regulation contained in 26 C.F.R. 1.861-8(e)(2)(ii) (1980).

"clarifies" the 1977 version (Pet. App. 12a). The 1987 version specifies that (26 C.F.R. 1.861-9T(a) (emphasis added)):

> Any expense that is deductible under section 163 (including original issue discount) constitutes interest expense for purposes of this section * * * . *The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year.* The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. * * * The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. * * * Consistent with the principles of fungibility, except as otherwise provided, *the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate*, have generated, or could reasonably have been expected to generate.

In noting that this new version of the regulation "clarifies" the preexisting requirement that "gross" rather than "net" interest expense be allocated among "all" business activities, the court of appeals rejected petitioner's contention that the new version of the regulation "substantially changed the rules for the apportionment of interest expense" (Pet. App.

12a). In the court below, if not here, petitioner thus recognized that the 1987 regulation requires allocation of "gross" interest expense to "all" business activities.

4. The 1987 regulation has now been in effect for more than a decade. There is no recurring administrative importance to the issue petitioner seeks to raise in this case concerning the "second" version of the regulation that applied for tax years between 1977 and 1987. Nor is there any conflict among the courts of appeals as to the meaning of the regulation for that period *or* for the period subsequent to 1987. Further review of the decision in this case is therefore not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 97-603

IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

BOWATER INCORPORATED AND SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY MEMORANDUM FOR THE PETITIONER

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REPLY MEMORANDUM FOR THE PETITIONER

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1. In our petition, we noted that the Second Circuit below and the Fifth Circuit in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), considered slightly different versions of the governing regulation. We nevertheless showed that the two decisions are in direct conflict because there is no meaningful distinction between the texts that the courts considered. The Government disputes this proposition. It contends that we have ignored an "obvious and highly pertinent distinction in the text of the two regulations" (Br. in Opp. 13 n.4) and it accordingly denies the existence of a circuit conflict (*id.* at 14).

The "obvious and highly pertinent distinction" on which the Government relies was the 1977 amendment revising the regulation to provide that interest expense shall be allocated "among 'all' income producing activities." Br. in Opp. 12.

But this amendment effected no substantive change whatever. The prior version of the regulation, considered by the Fifth Circuit in *Dresser*, similarly required that interest expense be properly allocated among "the items of gross income specified in §§ 1.861-2 to 1.861-7, inclusive." Treas. Reg. § 1.861-8(a) (as amended in 1975). The items of gross income specified in those six sub-sections comprised *all* categories of income listed in IRC § 861 as "income from sources within the United States." Thus, *both* versions of the regulation – the version considered by the Fifth Circuit in *Dresser* and the version considered by the Second Circuit below – required that interest expense be properly allocated among *all* income-producing activities. The substance of the two versions is thus identical; they simply use different verbal formulas to reach the same bottom line.

The Fifth Circuit in *Dresser* made clear that it saw no meaningful distinction between the two versions of the regulation at issue. Indeed, it explicitly relied on the 1977 text of the regulation – the version considered by the Second Circuit – as "illustrat[ing] the fundamental principle" on which it based its decision, namely, the "fungibility of money." *See* 911 F.2d at 1135; Pet. 9. Because the Fifth Circuit made plain that it would interpret both versions of the regulation the same way, there can be no doubt that it would decide the instant case in a manner opposite to that in which the Second Circuit decided it.

For its part, the Second Circuit below left little doubt that it regards the Fifth Circuit's interpretation of the regulation as erroneous. The Second Circuit takes *Dresser* to task for ignoring the "plain language" of the regulation and relying instead "on its own judicial version of 'economic reality.'" Pet. App. 7a-8a. And it asserts that "*Dresser's* * * * version of the 'true cost of borrowing' has no basis in the regulation"

and "does not comport with the Regulation's concept that money is fungible." Pet. App. 9a, 8a. The Government similarly describes the Fifth Circuit's decision as "misguided" (Br. in Opp. 7) and criticizes it for giving "no consideration to the 'plain text' of subparagraph (e)(2)(ii) of the 1977 regulation, which was controlling in this case." Br. in Opp. 13 n.4. In light of these criticisms of the *Dresser* opinion, the Government's denial of a circuit conflict rings extremely hollow.

2. The Government repeatedly asserts that the "plain language of the regulation" dictates the answer to the question presented here. Br. in Opp. 9, 10, 12, 13 n.4 & 14. Yet the Commissioner at trial agreed that the regulatory language was not "plain." In the Tax Court, "both parties recognize[d] that this regulation does not expressly state whether or not netting of interest is allowed." Pet. App. 23a. The Fifth Circuit in *Dresser* likewise found the regulation to be inexplicit or ambiguous. While agreeing that a literal reading of the regulation does not expressly require netting, the court observed that "the same literal reading does not preclude such an approach either." 911 F.2d at 1134-1135.

The regulation provides rules for allocation of "interest expense." Treas. Reg. § 1.861-8(e)(2)(i). The question presented – on which the Fifth and Second Circuits have reached different conclusions – is whether "interest expense" as used in this regulation means *gross* or *net* interest expense. Finding no clear answer in the text of the regulation, the Fifth Circuit considered congressional purpose, legislative history, and the economic realities of corporate borrowing in deciding that the term "interest expense" in this context is most logically interpreted to mean *net* interest expense. As the Tax Court recognized, the Commissioner's argument to the contrary "assumes its own conclusion: that interest income

should be considered separately, and not netted with interest expense." Pet. App. 25a. Thus, only by assuming what it is trying to prove can the Government assert that the "plain language of the regulation" supplies the answer to the question decided by the court of appeals.

Here, as in the court of appeals, the Government is using its mantra of the "plain language of the regulation" to disguise its unwillingness to discuss the question actually presented: whether the term "interest expense" as used in the regulation means *gross* or *net* interest expense. There is a clear division between the Fifth and Second Circuits on that question, and this Court should grant certiorari to resolve this conflict.

3. In our petition, we explained the immense practical importance of the question presented. The allocation of interest expense to domestic-source and foreign-source income affects dozens of computations under the Internal Revenue Code, most notably concerning the foreign tax credit. As the National Foreign Trade Council explains, the question presented "is of great importance to every U.S. company that does business overseas." Brief *Amicus Curiae* of the National Foreign Trade Council, Inc., at 6. A survey of 100 companies by the National Association of Manufacturers has shown that this issue is now pending in IRS audits involving tax liabilities in the range of $65 million. *See* Pet. 14. The question presented has arisen twice in the Tax Court since the instant case was decided. *See The Coca-Cola Company & Subsidiaries v. Commissioner*, 106 T.C. 1, 4, 31 (1996); and *Computervision Int'l Corp. v. Commissioner*, 71 T.C.M. (CCH) 2451, 2465 (1996).[1] Given the nature of this question,

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[1] We do not understand the Government's assertion that the Tax Court's opinions in *Coca-Cola*, *Computervision*, and the instant case "have not considered the governing text of the amended regulation contained in 26 C.F.R. 1.861-8(e)(2)(ii) (1980)." *See* Br. in Opp. 14 n.6. That is the

its resolution will ultimately affect the tax liabilities of virtually all U.S.-based multinational corporations.

The Government does not deny that the question presented is important in a highly practical sense to orderly administration of the tax laws. However, it notes that the regulation at issue has been amended a third time, effective for years after 1987. *See* Temporary Treas. Reg. § 1.861-9T(a).[2] The Government accordingly argues that there "is no recurring administrative importance" to questions concerning the proper interpretation of the earlier versions of the regulation considered by the Fifth Circuit in *Dresser* and by the Second Circuit in this case. Br. in Opp. 14-16. In effect, the Government urges the Court to wait and see if the existing circuit conflict persists in cases involving the new temporary regulation and, if so, consider a grant of certiorari at that time.

The Government's proposal would condemn taxpayers to many years of wasteful and unnecessary litigation. The question before the Court – whether the governing regulation requires allocation of "gross" or "net" interest expense – is squarely presented by the version of the regulation at issue here. The Justice Department in this case informed the court

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version of the regulation involved here, and it was obviously "considered" by the Tax Court in this case. This same version of the regulation was also at issue in *Coca-Cola* and *Computervision*, which involved those companies' 1985-86 and 1983-84 tax years, respectively. *See Coca-Cola*, 106 T.C. at 4, 31; *Computervision*, 71 T.C.M. (CCH) at 2464.

[2] Section 7805(e) of the Code provides, in the case of regulations issued after November 20, 1988, that "[a]ny temporary regulation shall expire within 3 years after the date of [its] issuance." Temporary Regulation § 1.861-9T(a) was issued on September 9, 1988 (T.D. 8228, 1988-2 C.B. 136) and it is therefore excluded from this automatic sunset rule.

of appeals that the new temporary regulation "simply serves to clarify the Commissioner's position" and that "the concept of fungibility did not change from one iteration of the regulation to another." Brief for the United States at 11, *Bowater, Inc. v. Commissioner*, 108 F.2d 12 (2d Cir. 1997). The Second Circuit agreed that "the temporary regulation merely reiterates, or clarifies, the Regulation at issue here" and found no evidence that it "substantially changed the rules for the apportionment of interest expense." Pet. App. 12a.

For these reasons, the new temporary regulation has little impact on the legal analysis involved in deciding the question presented. The instant case thus represents a perfectly appropriate vehicle for deciding that question and resolving the circuit conflict once and for all. Unless the Court grants certiorari, the inevitable result will be years of fruitless litigation and increasing inequities among taxpayers depending on their circuit of residence.

CONCLUSION

For these reasons and those stated in our petition, the petition for a writ of certiorari should be granted.

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Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

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BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE*

The National Association of Manufacturers (the "NAM") is the nation's oldest and largest broad-based trade association. Its more than 14,000 member companies and

* Pursuant to S. Ct. R. 37.6, counsel for *amicus curiae* state that this brief was not authored in whole or in part by a party and that no person or entity, other than the *amicus curiae*, its members and its counsel, made a monetary contribution to the preparation or submission of this brief.

subsidiaries, including 10,000 small manufacturers, employ approximately eighty-five percent of all manufacturing workers and produce over eighty percent of the nation's manufactured goods. More than 158,000 additional businesses are affiliated with the NAM through its Associations Council and National Industrial Council. Approximately eighty percent of NAM members are engaged in exporting or foreign direct investment, and the NAM's interest in the question of interest allocation is consistent with that of those members.

The issue before the court is whether the proper interest expense to be allocated and apportioned, pursuant to Treas. Reg. § 1.861-8(e), is net interest expense (gross interest expense minus offsetting interest income) or gross interest expense. The NAM is well-situated to address this issue. Many NAM members earn foreign source income and must comply with the regulations implementing I.R.C. § 861 to calculate foreign tax credit and/or Foreign Sales Corporation ("FSC") benefits.[1]

STATEMENT OF THE CASE

Amicus adopts the statement of the case and facts as set forth by Petitioner.

SUMMARY OF ARGUMENT

In *Bowater, Inc. v. Commissioner*, 108 F.3d 12 (2d Cir. 1997), the Second Circuit overturned the decision of the Tax Court and determined that the proper amount of interest to be

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[1] The Parties' written consent to the submission of this brief is on file with the Court.

allocated and apportioned under Treas. Reg. section 1.861-8(e) is gross interest expense. This holding is in direct conflict with the Fifth Circuit's decision in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), followed by the Tax Court in *Bowater*, which held that the appropriate measure of interest was net interest expense. *See Bowater, Inc. v. Commissioner*, 101 T.C. 207, 212, 214 (1993). The resolution of this split among the circuits is critically important because, although *Bowater* involves calculation of Domestic International Sales Corporation ("DISC") benefits and an earlier version of the regulations, substantially similar regulations currently govern the interest allocation crucial to a number of other calculations required by the tax code, most notably the calculation of foreign tax credit and FSC benefits. As illustrated by a recent NAM survey, hundreds of millions of dollars are at stake pending the resolution of this issue based on those two calculations alone.

ARGUMENT

I. THE SECOND CIRCUIT'S DECISION IN *BOWATER* IS AT ODDS WITH THE FIFTH CIRCUIT'S DECISION IN *DRESSER* AND THE RESOLUTION OF THIS ISSUE IS RELEVANT TO THE CALCULATION OF LIMITATIONS AND BENEFITS UNDER NUMEROUS INTERNAL REVENUE CODE SECTIONS

In 1990, the Fifth Circuit concluded in *Dresser* that the proper measure of interest to be allocated and apportioned under the regulations was net interest. The Second Circuit specifically declined to follow the *Dresser* holding when

deciding *Bowater*.

The Fifth Circuit, noting that the regulations specified the *method* of allocating interest expense but not the *amount* of interest expense,[2] determined that the fungibility concept underlying the regulation required the allocation of "the total *cost of the borrowing*," which, in the court's view, meant that interest paid and interest received should be netted against one another. The Second Circuit purported to rely on the plain language of the regulation and emphasized the required allocation to "all income producing activities" of the taxpayer, which it deemed to include the activity of producing interest income. Consequently, the court interpreted the regulation to require the allocation of the gross amount of interest expense since only a ratable portion would be allocated to the production of interest.

The Fifth Circuit correctly interpreted the concept of fungibility to ensure equality of treatment between similarly-situated taxpayers, regardless of management debt-structuring decisions. Resolution of the circuit conflict by this Court would ensure further that similarly-situated taxpayers are treated equally without regard to an accident of geography. If the current situation is allowed to persist, taxpayers located anywhere other than the Second Circuit will allocate net interest expense, while Second Circuit taxpayers will be forced to allocate gross interest expense.

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[2] *Dresser* involved the pre-1977 regulations, which differ slightly from those at issue in *Bowater*. However, there is no meaningful difference between the two versions. Both require the allocation of interest expense to all categories of gross income, and neither specifies whether such interest expense should be the net or gross amount. Additionally, the *Dresser* court expressly relied upon Treas. Reg. § 1.861-8(e)--the version applicable to *Bowater*--to support its holding. *Dresser* at 1135.

While the resolution of this issue in the instant case is relevant to calculation of DISC benefits, the proper method for apportioning interest expense is not limited to computation of DISC income. It is a pervasive concept affecting numerous determinations under the Code. I.R.C. section 861(b) and its implementing regulations govern the allocation of a variety of expenses, including interest expense, to determine a taxpayer's domestic-source and foreign-source income. Two of the areas in which these calculations have significant current applicability are the determination of foreign tax credit and Foreign Sales Corporation (FSC) benefits.

Although the Treasury Department amended the regulations again in 1988 such that they now appear on their face to moot the issue in the current case, the NAM agrees with the Justice Department and the Second Circuit that the new temporary regulation "simply serves to clarify the Commissioner's position" and that it "merely reiterates, or clarifies, the Regulation at issue here" and does not effect a change in the rules. Brief for the United States at 11, *Bowater, Inc. v. Commissioner*, 108 F.3d 12 (2d Cir. 1997); 108 F.3d at 17. Consequently, the new temporary regulation has little impact on the issue in the present case.

II. THIS ISSUE IS IMPORTANT TO U.S. MANUFACTURERS FOR THE CALCULATION OF THEIR U.S. TAX LIABILITY

As mentioned above, the allocation and apportionment of interest under Treas. Reg. § 1.861-8(e) is an integral step in the calculation of foreign tax credit and Foreign Sales Corporation ("FSC") benefits. Both of these provisions have a tremendous impact on the tax liability of U.S. companies

involved in exporting and foreign direct investment.

For example, in 1994 U.S. taxpayers claimed foreign tax credits totalling in excess of $25 billion. *See* Internal Revenue Service, 16 Statistics of Income Bulletin 204, Table 13 (Spring 1997). Foreign tax credit computation has a substantial effect on the tax liability of all U.S. companies with significant overseas operations.

Additionally, for Tax Year 1992, Foreign Sales Corporations filed 3,073 income tax returns, representing $152.3 billion in gross receipts. Eighty-six percent of all FSC returns filed were attributable to the export of manufactured products. *See* Internal Revenue Service, 17 Statistics of Income Bulletin 114, (Summer 1997). This translates into approximately $121.8 billion in gross receipts attributable to the export activities of just the manufacturing community.

A limited survey was sent this fall to representative NAM member companies in a wide cross-section of manufacturing industries, with a 24% response rate. Given that the average response rate to a mailed, voluntary survey is approximately 10%, the 24% response rate provides a statistically meaningful sample and can provide a basis for drawing valid conclusions. Of the respondents, 58 percent determined that the resolution of this issue would have an impact on their companies' tax liability for years ranging from 1979 to the present. For all of these companies, the interest allocation amount is relevant to the calculation of FSC and/or foreign tax credit benefits.[3]

The survey results also revealed that the proper measure of interest expense to be allocated under section 1.861-8(e) is

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[3] *See* App. A for complete survey results.

an important issue for more than half (fourteen) of the respondents, and, for more than half (eight) of those companies, the amount of money at issue exceeds $10 million per company. For six companies, the amount of potential tax liability exceeds $20 million per company. Even using the most conservative estimates, the aggregate amount of potential tax liability for just these eight companies exceeds $140 million.[4]

The substantial impact of this issue on the tax liability of U.S. manufacturers engaged in exporting and foreign direct investment, as demonstrated by the NAM survey and relevant income statistics, is strong evidence of the need for this Court to resolve the conflict among the circuits. The determination of how much of their foreign tax liability will be creditable against their U.S. tax liability has a direct impact on the profitability and competitiveness of U.S. companies in the global marketplace. Manufacturers that can be certain of the tax treatment of interest income and expense through this Court's ruling in this case will be in a better position to compete and grow worldwide.

CONCLUSION

The Second and Fifth Circuit Courts of Appeal have issued conflicting opinions regarding whether the proper measure of interest to be allocated under the section 861 regulations should be net or gross interest expense. As the resolution of this issue is significantly important to many U.S. multinationals and will substantially affect both the

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[4] The estimates used were $10 million for each company in the "$10 - $20 million" range and $20 million for each company in the "More than $20 million" range: (2 x $10 million) + (6 x $20 million) = $140 million.

prospective calculation of their U.S. tax liability and their potential retroactive liability on audit, the NAM urges that the writ of certiorari be granted.

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APPENDIX A

NAM Interest Allocation Survey Results
as of October, 1997

1. Annual sales of your company: **24 responding**

❑	Less than $5 million	**0**
❑	$5 million - $10 million	**2**
❑	$11 million - $49 million	**1**
❑	$50 million - $249 million	**0**
❑	$250 million - $1 billion	**1**
❑	More than $1 billion	**20**

2. Is the gross versus net interest calculation relevant to your company with regard to any issue currently under audit or for any open year? **24 responding**

❑ Yes **14** ❑ No **10**

3. If so, to what issues is this computation relevant? **15 responding**

❑	Computation of DISC benefits	**0**
❑	Computation of FSC benefits	**11**
❑	Computation of foreign tax credits	**11**
❑	Other (specify)_____	**0**

4. In what tax years is this issue relevant?

1995-97 (1)
1979-85 (1)
1993-1994 (1)
1992 to present (2)
1994 to present (2)
all open years (1)
1979-86 (1)
1988 to present (2)
1990 to present

5. What is your company's range of potential liability relevant to this issue? **14 responding**

❑	Less than $1 million	**4**
❑	$1 - $10 million	**1**
❑	$10 - $20 million	**2**
❑	More than $20 million	**6**
	Unknown	**1**